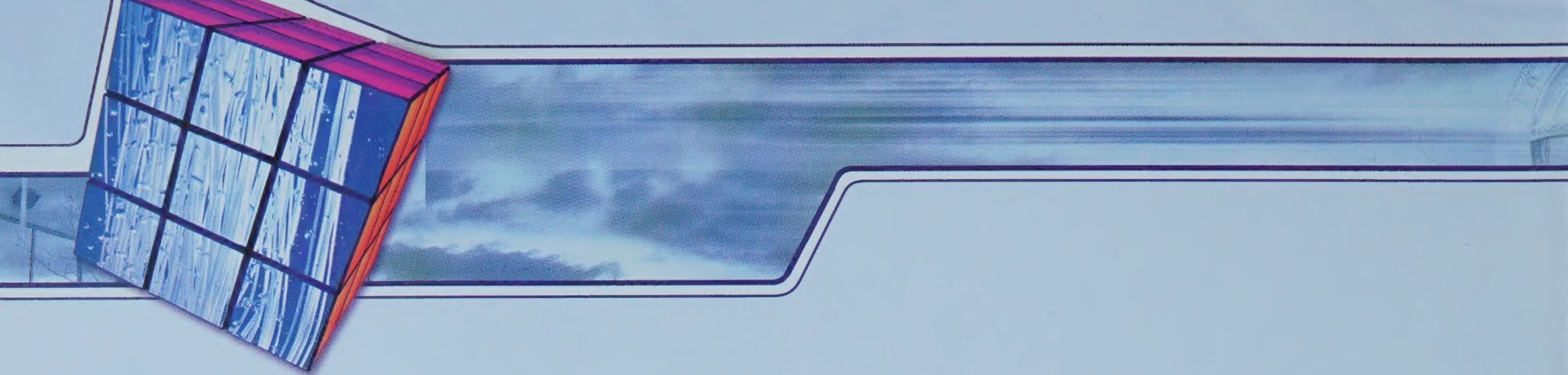
Getting It Right!

2002 Annual Report
ZENON Environmental Inc.

ZENON

Water for the World



"Just like a 'Rubik's Cube®' with its six coloured sides, ZENON's structure is comprised of Research and Development, Sales, Manufacturing, Engineering, Service and Finance. All these sides are now aligned and working well together. We have engineered a solid base for success and are 'getting it right'."

Andrew Benedek
Chairman & Chief Executive Officer

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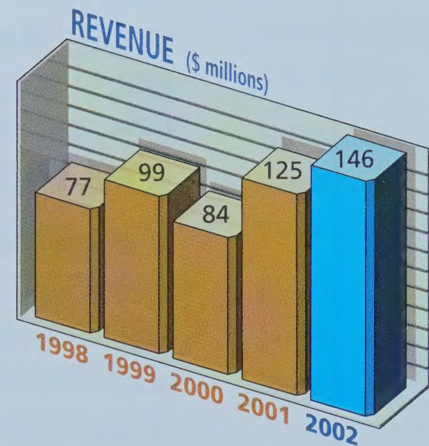
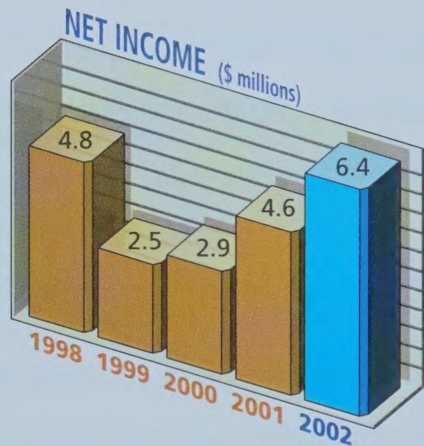
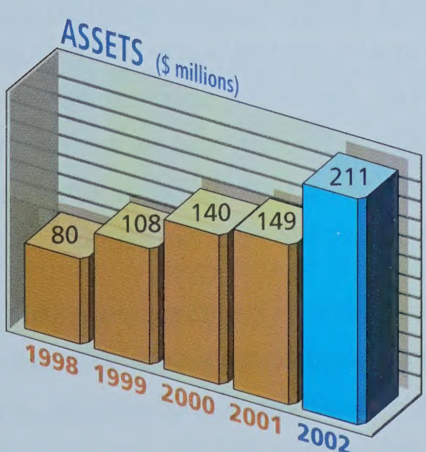
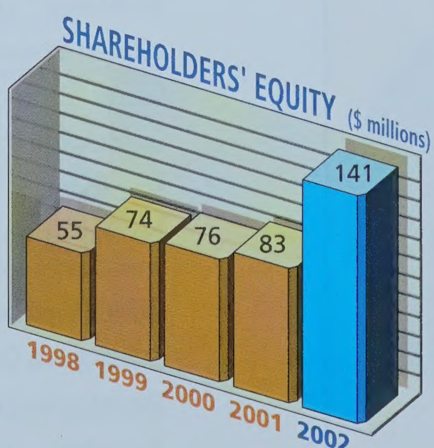
FINANCIAL HIGHLIGHTS

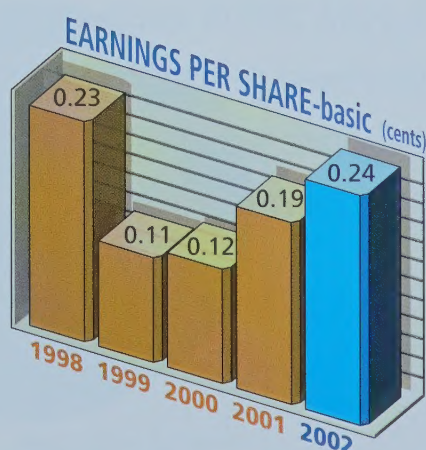
	[000's except earnings per share]	
	2002 **$**	2001 $
Total Revenue	**145,912**	124,711
Operating Income Before Taxes	**8,538**	6,911
Net Income	**6,439**	4,621
Net Income Per Share (basic)	**$0.24**	$0.19
Total Shareholders' Equity	**140,517**	83,338











1998 to 1999 figures adjusted to reflect 2-for-1 share split.

Research and Development

- Continuous product innovation and successful commercialization of ZeeWeed® membrane products
- Continuous cost reduction, allowing membrane products to be applied to new applications
- In 2002, ZENON introduced the newest generation of membrane technology – the ZeeWeed® 500d

LETTER TO SHAREHOLDERS

In summing up 2002, I can truly say that it was a strong year for ZENON with record revenue, bookings, backlog and profits. In addition, ZENON received notable recognition throughout the year for virtually all facets of our operations. This was a signal to us that we are "getting it right". Like a Rubik's Cube®, it's hard to align the different sides. But, once you do, you have a very solid structure. At ZENON we have done just that, aligned our core areas that include Research and Development, Sales, Manufacturing, Engineering, Service, and Finance to produce a solid, strong company.

Acknowledgements of our success came from areas such as exporting where ZENON received Canada's Top Exporter Award from the Department of Foreign Affairs and International Trade. This award notes a company's achievements beyond Canada's borders, realizing the importance of innovation and excellence in the products exported. For years, ZENON has sold our unique ZeeWeed® membrane products internationally and gained a reputation as a technology leader in the global water filtration market. Significant opportunities exist worldwide for ZENON's technology and we are looking to expand in all geographies, with particular emphasis on the Asian markets, over the next five years.

ZENON is the first company to be honoured with the prestigious Canadian Innovation Award for Sustainable Development, from Canadian Manufacturers and Exporters. This award signifies that we are achieving

excellence in product innovation and that the adoption and application of our technology is improving the environment for future generations. Our latest innovation came in 2002, when we introduced the ZeeWeed® 500d - a new generation of the ZeeWeed® 500 series specifically designed to meet the challenges of larger drinking water treatment plant designs. With each innovation, we improve space efficiency, quality and the ease of operation, while lowering capital operating costs.

In 2002, "Corporate Knights", a business publication that addresses corporate social responsibility, ranked ZENON as Canada's Top Corporate Citizen. This acknowledgement of business ethics was the culmination of all the elements that contribute to an organization's success, including community involvement, employee relations, environmental contribution, product safety and business practices, international dealings and finally share price appreciation. This one award brings all the different facets of the cube together.

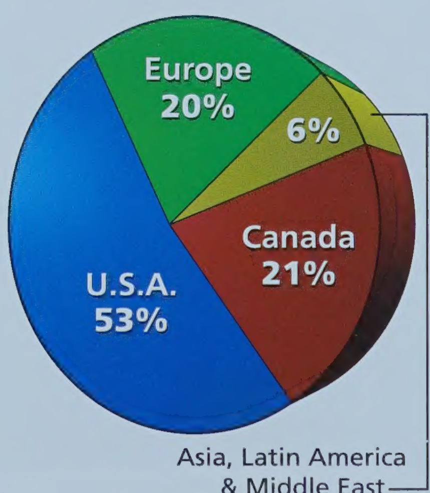
Other awards received during the year include:

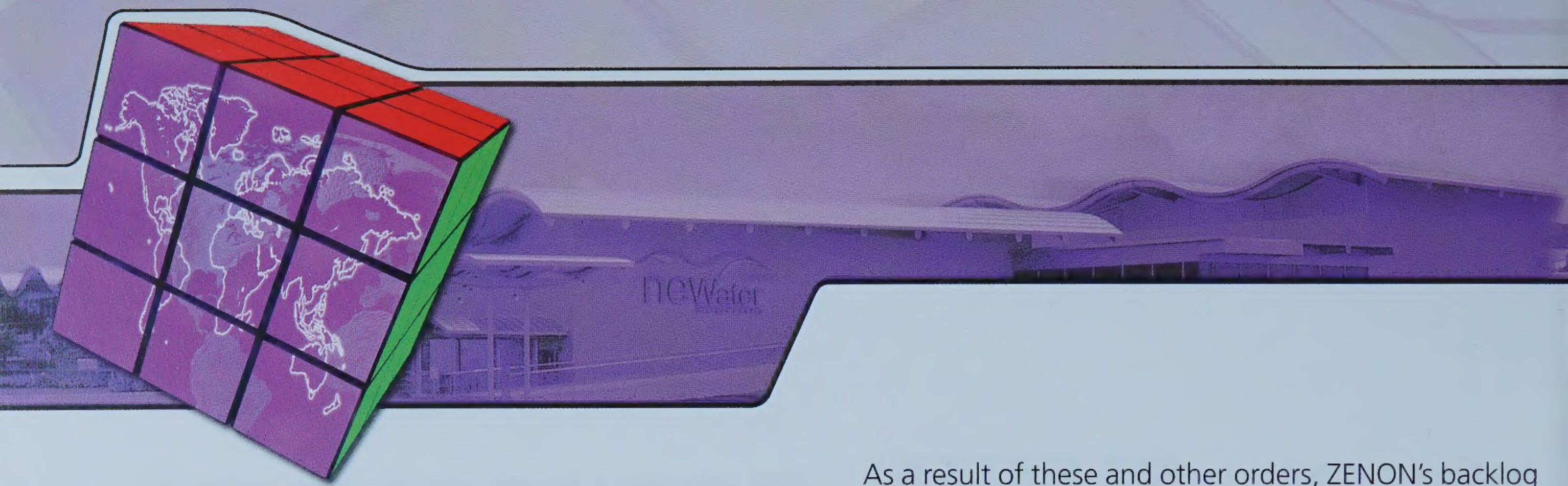
- Outstanding Business Achievement Award presented by the Ontario Chamber of Commerce (ZENON is the only company to date that has received this accolade twice);
- Product Achievement Award for development of the ZeeWeed® 1000 membrane from the Filtration+Separation Magazine Industry Award;
- Technology of the Year presented by Frost & Sullivan;
- Arthur Kroeger College Award for Management.

2002 was also a banner year for larger orders for ZENON's ZeeWeed® membranes. Contract wins in British Columbia, Michigan, Hungary and Singapore comprised ZENON's largest orders (by flow rate) to date.

- The City of Kamloops, British Columbia will have Canada's largest ZeeWeed® drinking water plant. *Contract value approximately $20 million.*
- Traverse City, Michigan will be the site of ZENON's largest North American municipal membrane sewage treatment plant. *Contract value approximately $10 million.*
- Hungary will soon have Europe's largest membrane based boiler feed water treatment plant. *Contract value approximately $8 million.*
- ZENON's largest ZeeWeed® installation to date is being built in Singapore. *Contract value approximately $10 million.*

2002 Sales by Region





Sales

- Established key reference sites worldwide to penetrate new markets
- Established strong sales network of ZENON representatives, system licensees and agents
- In 2002, as a result of strong relationships with customers, ZENON increased repeat business and booked several large sales orders
- Successful sales team makes ZENON a global market leader in membrane filtration

As a result of these and other orders, ZENON's backlog has grown to $164 million, 34% above our 2001 year-end backlog. In addition to this, we have been selected for orders totalling more than $100 million, the largest of which is the $30 million wastewater project for Gwinnett County in Georgia, U.S.A.

As well, we have been selected to provide the ZeeWeed® 1000 technology to a 36 million gallon a day drinking water plant that will be built in San Joaquin, California. Water shortages and environmental concerns have necessitated the use of treated surface water to supplement this area's existing ground water supply. The City of Scottsdale, Arizona has also selected ZENON as the preferred supplier for a new 30 million gallon a day drinking water plant currently being built.

On the European front, our six offices continue their excellent progress throughout the region with significant new municipal and industrial orders. This area offers a major market for our ZeeWeed® technology over the coming years. In light of this, we built a new state-of-the-art membrane manufacturing plant in Hungary. This facility was up and running by the end of 2002, producing high quality membranes.

Our partners are a critical component of our business and they ensure that we "get it right". ZENON currently has 14 licensees working with us to sell our membrane technology in Europe and Asia. Licensees have helped ZENON win projects, including the world's largest ZeeWeed® plant in Singapore and the world's largest membrane bioreactor plant in Germany. Our customers are also among our most important partners as we work

together to solve their water treatment problems. Their comfort and satisfaction with our products has become evident over the years as the number of repeat orders continues to increase.

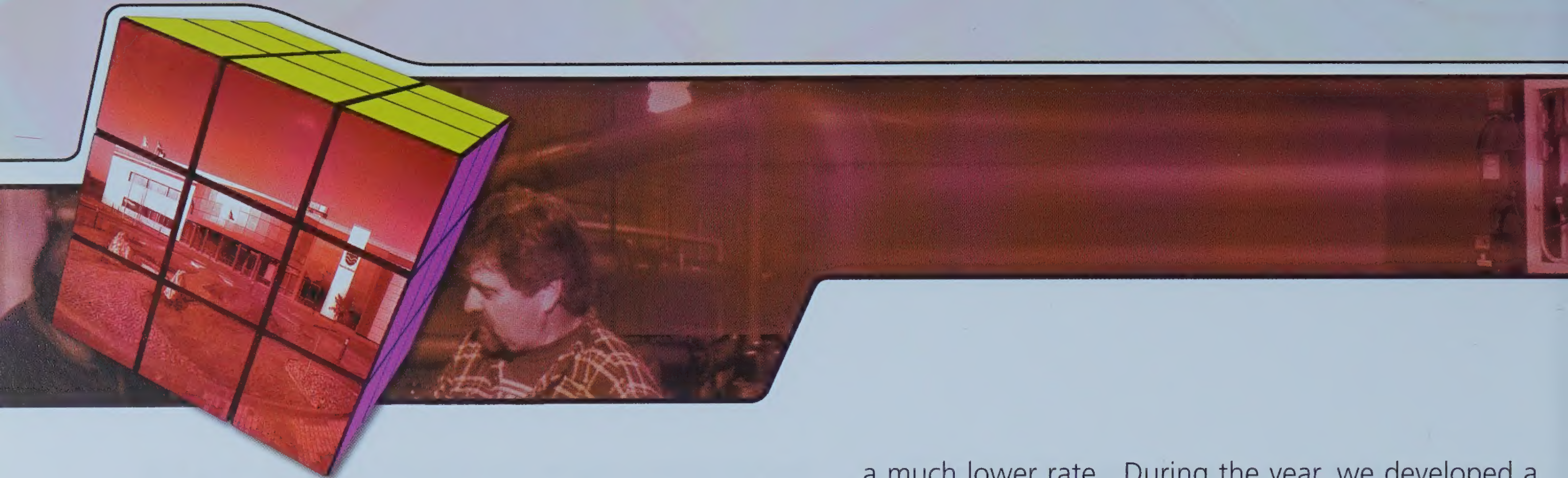
Successful adoption of ZENON's technology is inherent in our most recent orders from repeat customers. The Olivenhain drinking water treatment plant outside of San Diego, California, U.S.A. is the largest installed ultrafiltration plant in North America, producing 25 million gallons of water per day. The second phase of expansion has commenced with an engineering order for ZeeWeed® membranes that will bring treated flow to 34 million gallons per day.

A number of areas in the United States are experiencing serious water shortages and the State of Georgia is among them. The State has proclaimed water reuse one of its primary goals and has taken action to reuse treated wastewater for non-potable purposes. Our first ZeeWeed® wastewater reuse plant in that State will also be expanding in 2003 with the possibility of future similar plants throughout Georgia.

The main operational achievement in 2002 was the successful start-up of the Hungarian membrane manufacturing plant. All production and quality targets have been met with the plant producing over $1 million of membranes in 2002. As of February 2003, the plant is operating at full capacity for stage 1 of its operations, producing an equal number of membranes as our Canadian facility. Space is available to increase the Hungarian manufacturing plant by a factor of 4 over the coming years.

Throughout 2002, we continued to make great progress in streamlining global operations. We expanded sales and operations, while increasing overhead expenses at

European membrane manufacturing plant – Hungary



Manufacturing

- Established global membrane manufacturing and system assembly facilities, dedicated to producing the highest quality products
- Committed to continuous cost reduction through process automation and establishing economies of scale
- In 2002, ZENON's new European membrane manufacturing plant was brought on-line and the North American membrane production plant was expanded to meet the growing demand for ZeeWeed® products

a much lower rate. During the year, we developed a line of fully standardized small drinking water and wastewater units, which are already proving to be a success. Further efficiencies were created in membrane manufacturing in Canada as we expanded by over 50% in the same building footprint. Poor performing operations in the Middle East and Boston, U.S.A. were reorganized with much of the support for these regions now being provided out of our corporate headquarters in Canada. As a result, for the second year in a row, ZENON achieved a record low SG&A (selling, general and administrative expense) of 23% of revenue.

ZENON's management team has been strengthened with the addition of Daryl Wilson, formerly Vice President of Toyota's Canadian manufacturing plant. Mr. Wilson was hired as Vice President, Manufacturing, as Upen Bharwada assumed the role of Vice President, Business Development to further strengthen ZENON's global business development. To further build on our international sales, Diana Mourato has transitioned from the Municipal division to head our International division as Vice President, International. She will work to replicate her success of growing ZENON's North American municipal operations from $0 in sales to becoming the largest municipal membrane system supplier in North America over the past decade. Steve Watzeck, formerly Director of Municipal Sales, has assumed the position of Vice President, Municipal.

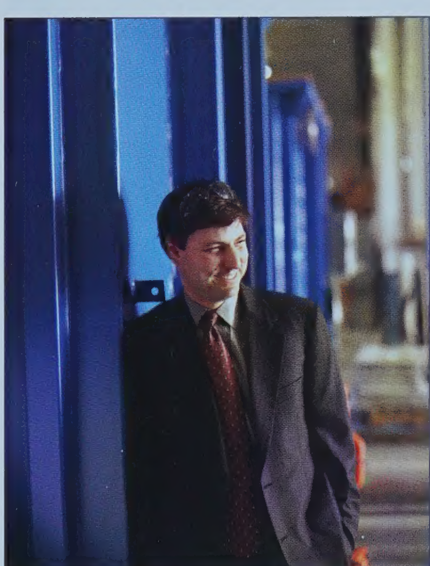
ZENON's balance sheet is stronger than ever with virtually no debt, full ownership of all major assets, and $16 million in cash. In addition, we reduced our working capital by a further $8 million in 2002. When

combined with the $25 million reduction achieved in 2001, this resulted in a $33 million decrease in working capital over the last two years, while achieving a 73% increase in revenue over the same period.

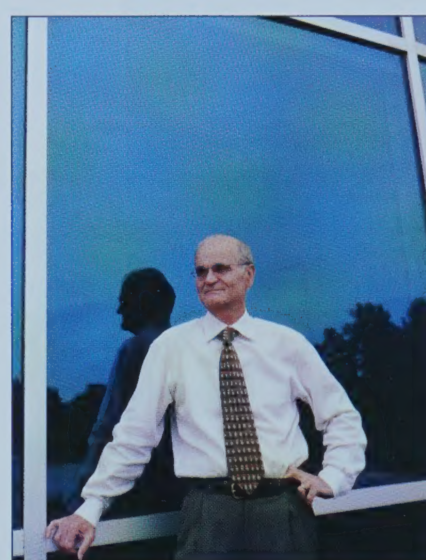
Our growth and performance strategy is simple and will allow us to continue "getting it right". We will:

- Grow sales of our proprietary ZeeWeed® membranes;
- Expand ZENON's presence in existing market segments;
- Build on niche applications;
- Build partnerships;
- Produce high quality products while simultaneously reducing costs;
- Improve existing products while successfully commercializing new products to maintain our leadership position.

Not very frequently does a company have an opportunity to revolutionize an industry from the ground up and produce solid results. ZENON is in a unique position to drive the market and affect change in the way water treatment is looked at today, while continuing to develop better, faster, cheaper ways of doing so. This kind of opportunity can only be successful with the right combination of staff, customers and shareholders who can see the long-term potential of our business.



Rafael Simon
Chief Operating Officer



Andrew Benedek
Chairman and Chief Executive Officer

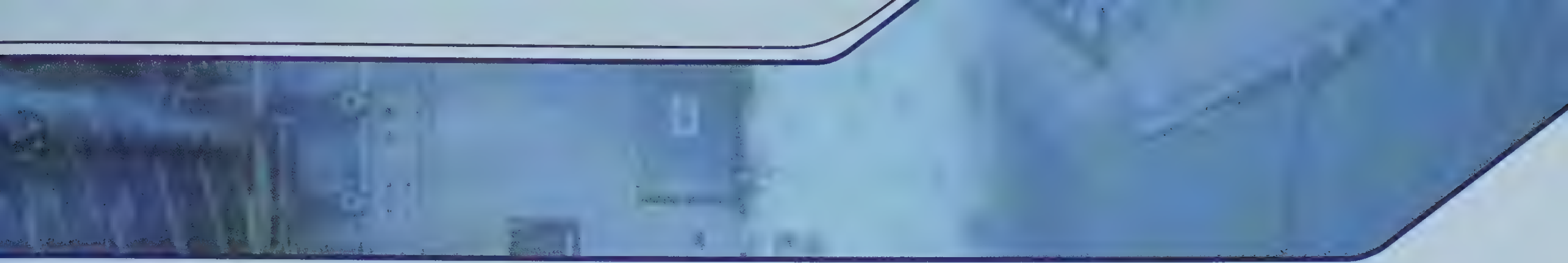
Engineering

- Developed reliable systems that can filter virtually any type of water
- Recruited and developed the right people, with the right experience to build treatment plants of any size
- Continue to develop new systems for new market sectors with commercial success
- In 2002, ZENON introduced the Modular Drinking Water and Modular Wastewater Treatment systems

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis provides information that Management believes is relevant to an assessment and understanding of the Company's consolidated results of operations and financial condition. Management has prepared this document in conjunction with its broader responsibilities for the accuracy and reliability of the financial statements, the development and maintenance of appropriate information systems and internal controls to ensure that the financial information is complete and reliable. The Audit Committee of the Board of Directors, consisting of independent directors only, has reviewed this document, and all other publicly reported financial information, for integrity, usefulness, reliability and consistency.

This discussion should be read in conjunction with the Consolidated Financial Statements and accompanying notes. Certain statements contained in the Management's Discussion and Analysis of financial condition and results of operations contain forward-looking statements, relating to the operations or to the environment in which we operate, which are based on our operations, forecasts, and projections. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions, and the Company's actual results may differ materially from those anticipated in these forward-looking statements.



OUR VISION

ZENON is engaged in the design, development, manufacture and application of membrane technologies for water and wastewater treatment. The Company was founded in 1980 on a vision of a world where cost-effective membrane technology could ensure humanity's survival with safe and superior quality water.

At ZENON, we believe that membranes are the solution needed to overcome water shortage and quality issues worldwide. To this end, we have developed proprietary membranes that can be used in various applications for purifying drinking water and treating wastewater for either discharge or reuse for non-potable purposes. Core to our business is the continuous development and improvement of our proprietary membranes. Our goal is to set higher standards for water and wastewater treatment through the use of cost-effective membranes, while reducing energy and chemical requirements.

The new ZeeWeed® 500d membrane

Today, ZENON employs over 850 people who operate out of 17 offices in 11 countries, providing technological solutions for municipalities, industries, land developers, homeowners and emergency response applications.

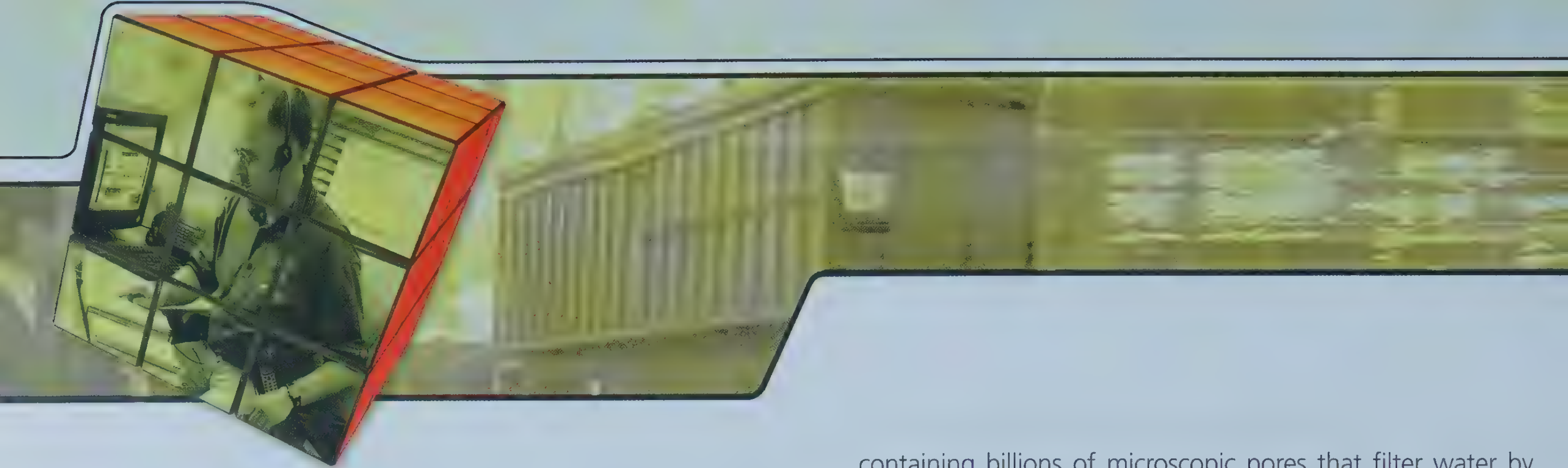
ZENON's primary product is its proprietary polymeric membrane, sold under the trade name ZeeWeed®. The Company sells this product on a stand-alone basis and as part of an advanced water and wastewater treatment system.

These systems:

1) Purify drinking water to the highest possible standards to improve public health;
2) Treat any type of municipal or industrial wastewater to near drinking water quality;
3) Recycle effluent to alleviate water shortages; and
4) Provide high quality industrial feedwater to reduce industry costs and improve reliability.

The markets for our products are growing rapidly as reserves of potable water continue to diminish worldwide and as environmental standards for the quality of water and wastewater become increasingly stringent.

ZENON operates in one business segment that involves the manufacture of membrane based water and wastewater treatment systems. Membranes are thin polymeric films



containing billions of microscopic pores that filter water by blocking the passage of all particles larger than the size of the pores in the membrane, including contaminants such as parasites (i.e. *Cryptosporidium*), bacteria (i.e. *E. Coli*) and viruses, as well as inorganic and organic debris. Membranes are now considered the best available technology for water treatment, because they are simple to use, offer chemical-free treatment, and produce constant and reliable water quality.

Our strategy is to:

- Sell proprietary ZeeWeed® membranes and membrane systems:
  - Directly to the customer,
  - Through representatives,
  - Through licensees;
- Expand ZENON's presence in existing market segments and build on niche applications for products to complement our competitive advantage;
- Build partnerships;
- Produce high quality products while reducing costs;
- Improve existing products and successfully commercialize new products to maintain membrane technology leadership.

Membrane technology development and production are managed globally from our corporate office in Oakville, Ontario, Canada. With the opening of our new membrane plant in December 2002, we now have two membrane manufacturing plants, one in Burlington, Ontario, Canada and the other in Oroszlány, Hungary. Research and development ("R&D") supporting both our membrane

Service

- Developed a centralized team of field service personnel to provide high quality technical service and support worldwide
- 24/7 response by dependable customer service technicians who are client driven
- In 2002, ZENON introduced new Internet based technologies that simplify plant operations and lower operating costs for the customer

manufacturing and our system design and assembly will be carried out in both locations, once construction of a new R&D facility in Hungary is completed in 2003.

ZENON's system business is managed on a regional basis, split between North America and International. To support our customers, we have Sales/Engineering offices in both regions. For North America, the Canadian offices are located in Ontario and Alberta. The primary U.S. offices are located in California. Internationally, we have Sales/Engineering offices in Germany, The Netherlands, United Kingdom, Italy, Hungary, Poland, Brazil, Singapore and the United Arab Emirates.

Our objective is to grow sales at or above the industry's growth rate, which we expect to average at least 20% per year. The recent opening of our new membrane production plant in Hungary will allow us to meet the growing market demand for membrane filtration technology.

Cauley Creek wastewater reuse facility – U.S.A.

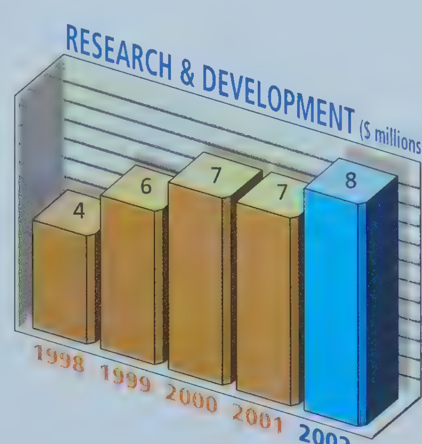
MANAGEMENT'S KEY PERFORMANCE INDICATORS

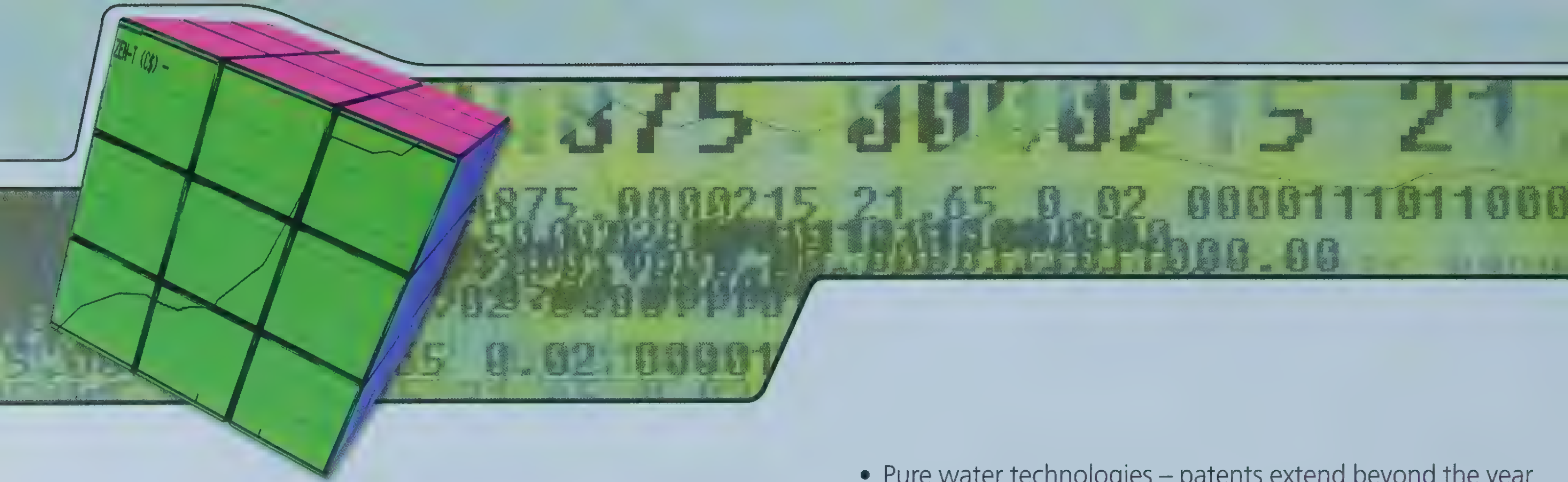
Since inception, ZENON has constantly had the challenge of managing growth. Management focuses on the following areas as drivers of the business model to ensure the long-term growth, profitability and return to its shareholders.

Research and Development

To be continuously successful in the market place, we put significant emphasis on the research and development of improved membranes and systems. Our commitment to R&D is a key area of our philosophy. ZENON's policy is to seek patent protection for both the methodology and underlying technology of its inventions whenever possible. This investment has helped us to maintain patent coverage for the following key products:

- Membrane bioreactor – patent coverage extends beyond the year 2010 and covers major countries globally;
- ZeeWeed® hollow fibre filtration system – a number of patents cover North American and other major markets with coverage extending beyond the year 2010;





Finance

- ZENON has never been as strong financially
- Virtually no debt
- Ownership of all assets
- Strong focus on cash management
- In 2002, ongoing reduction in working capital contributed to cash balance of $16 million

- Pure water technologies – patents extend beyond the year 2010 and cover the United States;
- Mobile water treatment system – patents in this area cover the United States and Europe and extend to the year 2010.

ZENON owns a number of other patents in technologies, processes and products that are of secondary importance, but offer long-term potential. In addition, current trademarks include ZENON®, the ZENON logo, ZeeWeed® and ZenoGem®, all of which are registered in the U.S.A. and many countries around the world.

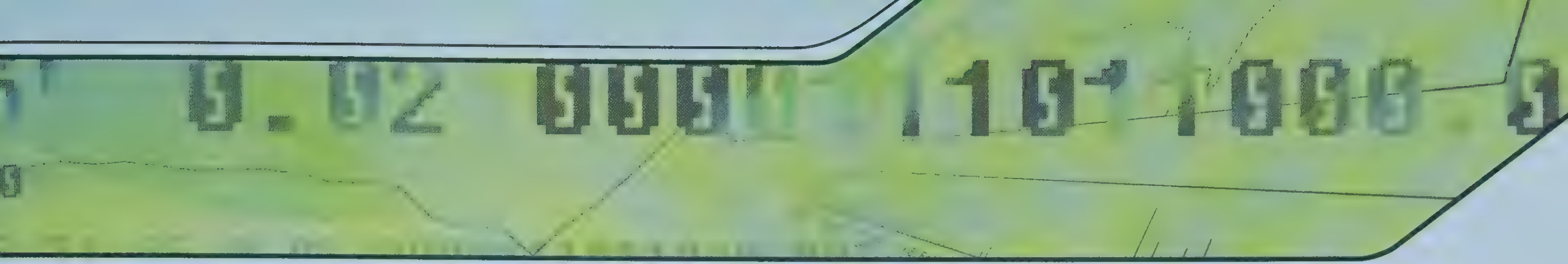
Bookings and Backlog

At ZENON, we measure performance and expectations for future revenue by closely monitoring our bookings and backlog. Bookings are defined as orders that are received and supported by a firm purchase order. Backlog represents the amount of revenue left to be recognized from the current orders on hand.

Revenue for significant contracts is recognized on a percentage-of-completion basis. Contract cancellations are reflected in revenue once certainty exists regarding their collectibility. Revenue from all other contracts is recognized on the completed contract basis.

Overhead expenses

We expect our selling, general and administrative (SG&A) costs to increase at a rate less than our revenue. Although our SG&A as a percentage of revenue can fluctuate quarterly as a result of overhead allocations charged to product costs, based on the Company's activity levels and product mix, management's current expectation is to see reduction on a year-over-year-basis. As the Company's revenue grows, management will continue to focus on this area to control costs.



Employment

Employees are a key component of the Company's success. We set high standards for hiring while promoting a work place that will attract the best people. On an ongoing basis, we identify our key employees and have a very high record of retention for these individuals.

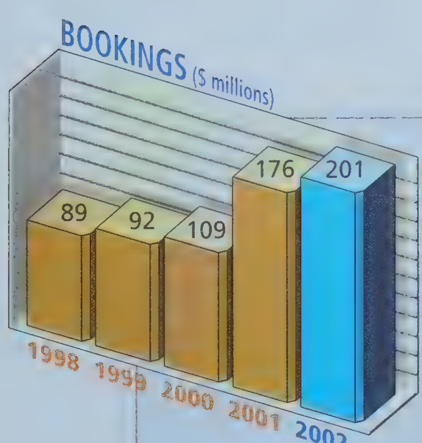
The Company's retention rate and the success of all employees are key monitors used by management to ensure the Company has the right employment base, as well as the right employment environment, to meet the growth of the business.

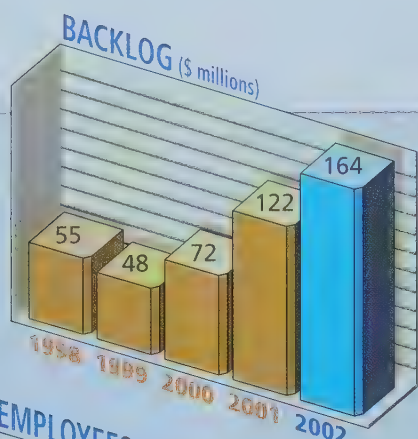
RESULTS AND CAPABILITIES

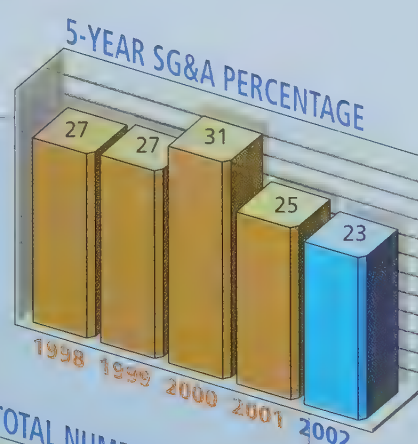
Our results continue to reflect the investments we have made in employees, capital assets and our other business partners throughout the world.

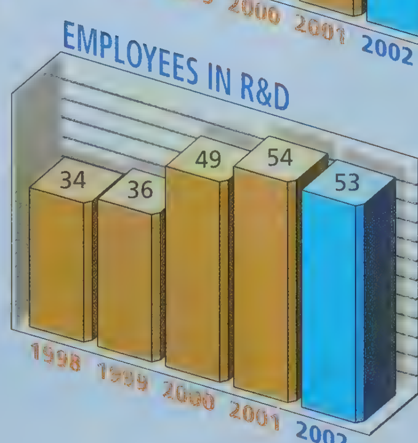
Significant Events

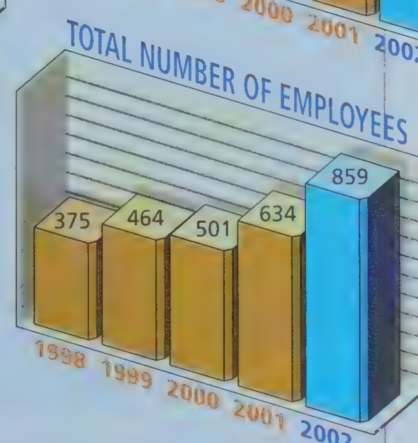
In February 2002, the Company completed the sale of two million non-voting Class A shares and one million common shares for aggregate gross proceeds of $42.5 million. The proceeds were used to repay the revolving term facility of $10 million and to fund the construction of the new membrane manufacturing plant in Hungary.





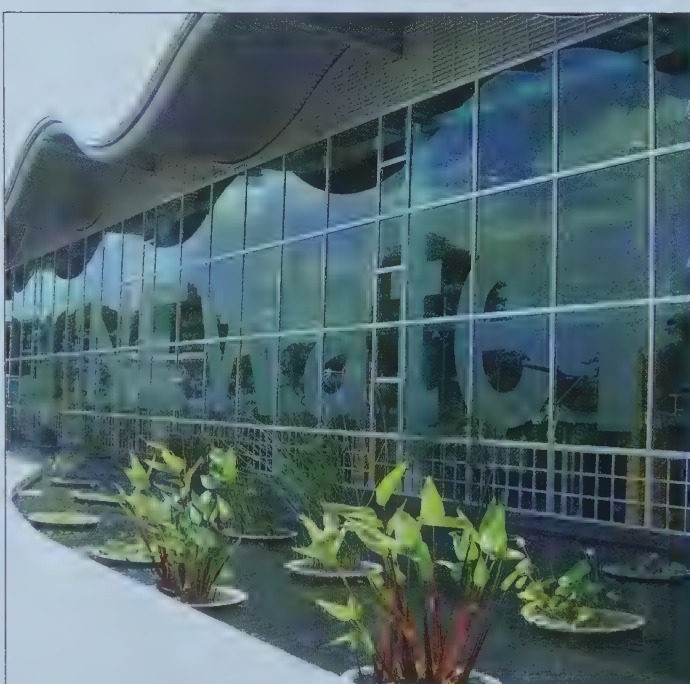






At the beginning of December 2002, we commenced commercial production at our new membrane manufacturing plant in Oroslány, Hungary. The initial production capacity of this facility equals the current membrane production capacity of our Burlington manufacturing plant. The plant in Hungary is 12,000 square metres and has enough floor space to quadruple current production there.

During the second quarter of 2002, we completed work on a new water reclamation plant in Singapore, which was officially opened in February 2003. This order was a strategic investment that allowed ZENON to establish a reference site in the country, in addition to becoming Singapore's showpiece plant in its commitment to recycling wastewater.



Bedok wastewater reuse facility – Singapore

This region represents the single largest potential market, over the long-term, for membrane technology. In light of this, we decided to undertake an investment in the area, even though it impacted negatively on the results of the second quarter. The order consumed over one month of ZENON's membrane production capacity, preventing the Company from realizing revenue on normal margin membrane and system sales for the period. We have since seen the benefits of this strategic venture. In November, we announced that ZENON was awarded a contract to supply our ZeeWeed® membranes for a new drinking water plant to be built in Singapore. At the time of our announcement, this new 72 million gallon per day plant was the largest drinking water order ZENON had received.

Change in Accounting Policies

Effective January 1, 2002 the Company adopted the Canadian Institute of Chartered Accountant's new recommendation for the measurement, presentation and disclosure of goodwill. Goodwill is no longer subject to amortization, but is subject to an annual assessment for impairment by applying a fair value test with any impairment in the value of goodwill being charged to earnings. If goodwill had not been amortized in 2001, net earnings for the year would have increased by $279,000.

Operations

We are very pleased to report another year of record bookings, record backlog, record revenue and record profit. Our past investments in our employees and capital assets continue to pay off and will continue to do so in the future. Revenue for the year ended December 31, 2002 was $145.9 million, an

increase of 17% over the previous year's revenue of $124.7 million. New orders booked in the year totalled $201 million compared to $176 million in 2001. The backlog at December 31, 2002 of $164 million is 34% higher than the closing backlog at the end of 2001 of $122 million. The backlog positions the Company very favourably going into 2003.

North American revenue grew 13% in the year to $107 million and International revenue grew 31% to $39 million. Within North American revenue, growth in the United States of 43% offset a Canadian revenue decline of 26%. This decline in Canada reflected the timing of revenue recognition over a two-year period. We are continuing to see strong bookings from the Canadian market.

In 2001, International revenue included $2.9 million for the cancellation of a contractual arrangement. In 2002, there was no revenue relating to cancellation of orders. The Company regularly enters into distribution agreements that allow distributors to assemble and sell water and wastewater treatment systems using ZENON's proprietary membranes. During 2002, revenue of $1.2 million was recorded relating to the establishment of these agreements, compared to $2.9 million in 2001. These distribution agreements provide ZENON with another channel to sell the Company's products worldwide and to support our continued revenue growth in the future.

Campbeltown/Argyll wastewater treatment plant – United Kingdom

Gross profit as a percent of revenue was 35.4% compared to 38.4% in 2001. While we have seen erosion in the overall margin percent, the margin on our normal membrane and system business improved in 2002. Although we are faced with very competitive market conditions, management continued its focus on reducing and controlling manufacturing and project costs. These factors, along with the standardization of product components, have allowed the Company to maintain a strong gross margin. The margin improvements were offset by the ongoing investment in pilot plants and the discounts required for penetration into certain strategic market sectors, including Singapore.

Also in the year, warranty provisions were increased by $2.3 million ($2.0 million in 2001) to reflect the risk relating to the increasing number of membranes being used in the market place. To date, there have been minimal warranty claims. However, as warranty periods are increasing, we believe it is prudent to increase the provision for this potential risk.

Selling, general and administrative expenses increased by 10% to $33.9 million compared to $30.8 million for 2001. The growth

in SG&A expenses is within management's target range and meets our commitment to contain overhead at a lower rate of growth than revenue growth, which was 17% for the year. Overall SG&A expenses as a percent of revenue were 23.2% for 2002 compared to 24.7% for 2001. This is the lowest level as a percent of revenue in the Company's history.

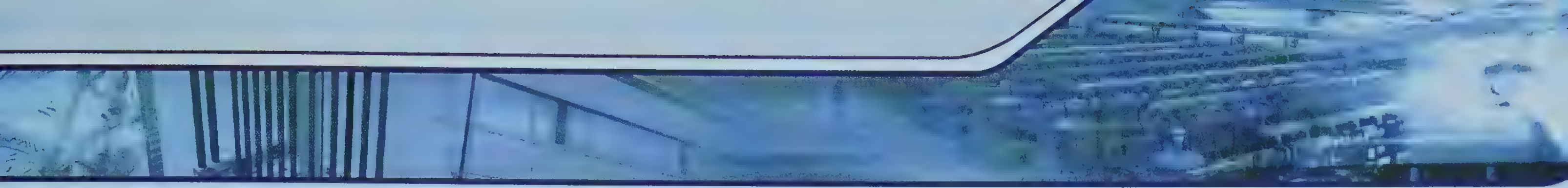
We are committed to investing in research and development. At $8.2 million for 2002, our investment in R&D was a 19% increase over the $6.9 million investment in 2001. Of the $8.2 million, approximately $4.5 million has been received or is receivable from external funding, resulting in a net expenditure of $3.7 million in 2002, compared to a net expenditure of $2.3 million in 2001.

In 2000, ZENON was awarded a $9.9 million repayable grant (to be received over 3 years) from Technology Partnerships Canada for advanced research into improving energy efficiency and performance standards in membrane based water treatment. To date, the Company has claimed $9.8 million ($6.2 million in 2001), of which $7.7 million has been received and $2.1 million is reflected as accounts receivable. Of the $9.8 million claimed, $5 million is reflected on the consolidated balance sheet as a deferred technology credit and the balance of $4.8 million as an offset to other assets. Ongoing innovation and investment in research and development is a major driver for the Company, which will continue to position ZENON as the market leader in membrane based technology.

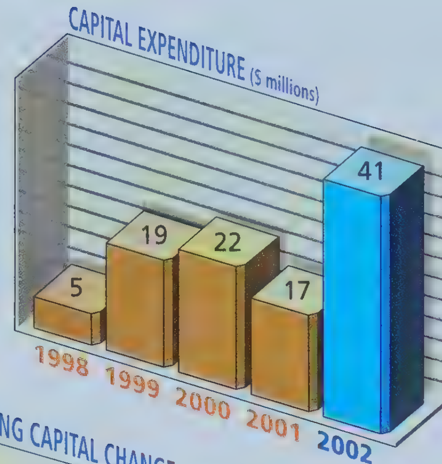
Leipzig wastewater treatment plant – Germany

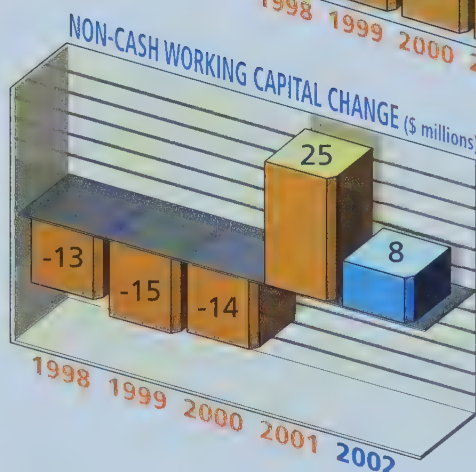
Amortization increased by $1.7 million in the year as a result of the Company's prior years investments in membrane production and technology, in support of growing the business. Net interest was an income for the year of $624,000 compared to an expense of $2,038,000 for 2001. The interest income for 2002 is a result of ZENON's equity issue in February 2002 and management's consistent focus on cash.

Total future income taxes increased by $1.2 million in the year; mainly as a result of the costs associated with the share issue in February 2002 and the Company's claim for R&D tax credits. At the end of 2002, the future tax asset was $3.1 million. We believe that based on the Company's performance and its plans going forward, the balance of this tax asset will be utilized. The minimum amount of future taxable income required to realize this future tax asset is approximately $8.9 million. The effective income tax rate for the year was 24.6% (2001 – 33.1%). The decrease in the tax rate reflects an improvement in the geographical distribution of profits.



Operating income of $8.5 million ($6.9 million – 2001) and net income of $6.4 million or $0.24 per share (2001 - $4.6 million/$0.19 per share) were both records for the Company. Overall performance continues to improve as a result of our focus on growth and profitability. Our employees continue to be a key factor to our success. Their focus, dedication and hard work will continue to be one of the main contributors to our successful future.





Quarterly Review

ZENON traditionally has stronger performance in the third and fourth quarters as revenues improve, relating to the finalization of projects during that time.

In the first quarter of 2002, the Company completed the sale of two million non-voting Class A shares and one million common shares. The increase in shares is reflected in the net earnings per share calculation for each of the quarters in 2002.

Eight-Quarter Comparison

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		Full Year	
	2001	**2002**	2001	**2002**	2001	**2002**	2001	**2002**	2001	**2002**
(000's except for earnings per share)	$	**$**	$	**$**	$	**$**	$	**$**	$	**$**
Revenue	23,476	**29,774**	29,389	**27,216**	32,216	**36,577**	39,630	**52,345**	124,711	**145,912**
Operating income (loss) before income taxes	389	**603**	815	**(1,472)**	2,634	**3,329**	3,073	**6,078**	6,911	**8,538**
Net earnings (loss) for the period	(238)	**428**	573	**(1,085)**	2,134	**2,443**	2,152	**4,653**	4,621	**6,439**
Net earnings per share										
Basic	(0.01)	**0.02**	0.02	**(0.04)**	0.09	**0.09**	0.09	**0.17**	0.19	**0.24**
Fully Diluted	(0.01)	**0.02**	0.02	**(0.04)**	0.09	**0.09**	0.09	**0.16**	0.19	**0.23**

During the second quarter of 2002, the Company completed a sale of its membranes for a new water reclamation plant in Singapore. As stated previously, this was a critical strategic investment for the Company. The order consumed over one month of the Company's membrane production capacity and negatively impacted the revenue and profit results for the quarter.

Excluding the second quarter of 2002, the results of the Company reflect the ongoing growth of the business resulting from the continuously increasing acceptance of the Company's technology in the market place. Overall for the year 2002, revenue grew by 17% and net earnings grew by 39%.

Capital Expenditures

Over the last four years, the Company has invested heavily in capital assets to improve and increase production capacity. In 2002, capital asset purchases were $41 million, as a result of building the new Hungarian membrane production plant. We are confident that with our expansion initiatives over the last few years, we are in a strong position to support the future growth expectations of the market place.

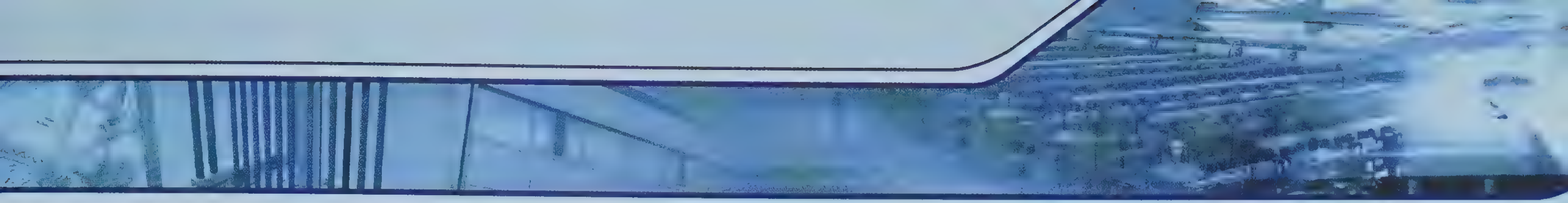
Liquidity

During 2002, the Company renegotiated its credit facilities with certain bankers. The Company's current bank credit facilities total $107.2 million compared to $118.6 million at the end of 2001. As a result of the equity issue in February 2002, a revolving long-term facility was paid down and cancelled, reducing the existing facility by $15 million. For a breakdown of the credit facility, reference should be made to note 7 in the financial statements.

Cash flow provided from operating activities was $23.3 million in 2002 compared to $38.7 million in 2001. The decrease in 2002 is a result of less cash being provided from non-cash working capital balances relating to operations. In 2001, the Company reduced non-cash working capital relating to operations by $24.6 million and in 2002, continued to reduce these balances by another $8.0 million. The overall improvement to working capital in the last two years of $32.6 million reflects management's focus on cash, particularly when compared to revenue growth over the same two-year period of 73% ($61.4 million).

During 2002, the Company utilized $46.2 million ($19.9 million 2001) in cash to invest in the future growth of the business. The majority ($41.5 million) was for capital expenditures as previously discussed. Also, during the year, capital and business unit assets were sold and generated cash for a total of $1.3 million ($3.0 million – 2001). The 2002 disposals included the sale of excess equipment and land,

Boiler feed systems for power generation plant – Eastern Europe



and also the sale of a small non-core de-ionization service centre business unit located in Massachusetts, U.S.A.

Investments in patents, goodwill and other assets were \$5.7 million in 2002 compared to \$6.1 million in 2001. The major component of this increase was the investment in the development of new membrane based water treatment products, including the ZeeWeed® 1000, which continued to be financially supported by Technology Partnerships Canada throughout 2002.

As stated previously, the Company raised equity in February for a total of \$42.5 million with a portion of the proceeds being used to repay the revolving term facility of \$10.0 million.

Overall for the year, \$10.3 million of cash was generated and current and long-term bank debt of \$10.5 million was paid down. At the end of the year, the Company had cash and cash equivalents of \$15.8 million, no current bank indebtedness and long-term debt of \$555,000 relating to obligations under capital leases and government interest-free loans.

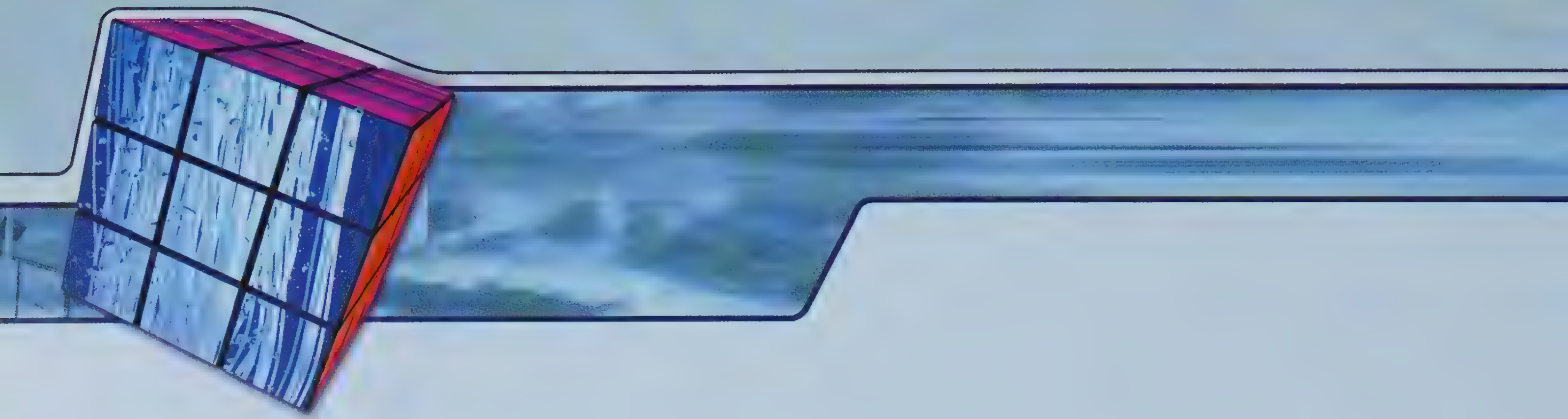
Other

The number of employees grew from 634 to 859 during 2002. Over 60% of this increase was to staff our new plant in Hungary. The balance of the increase was to support our order and revenue growth during the year. We expect revenue growth to range between 20%-30%. To achieve this level of growth, we will need ongoing investment in the Company's work force as well as additional capital investment. Through innovation and improved systems, the growth in the work force is expected to be less than the rate of revenue growth.

In 2002, the Company received regulatory and board approval to purchase from and issue to a related party who is an officer and shareholder of the Company, 7,794,584 common shares. The Board received an independent opinion to confirm that there was no impact to the Company in regards to this transaction. All costs relating to the transaction were paid by the third party.

Over the last few years, we have invested in a Business Enterprise System for our North American Operations. In 2002, we installed this system in the new Hungarian production plant. We see the need to standardize our processes to allow for proper analysis and control to meet our growth, creating greater efficiencies. We feel confident that this integrated management information system is adequate for our current needs and can expand to meet our future requirements.

Based on the Company's current cash position, the available credit facilities and future cash flows, we believe that ZENON will have sufficient funds to meet all of its anticipated cash needs for the financing of the business over the next 12 months. We also believe that, based on our balance sheet and current and expected profit performance, the Company is strongly positioned to meet the cash requirements necessary for future growth over the long-term. For a detailed breakdown of future commitments and contingencies, reference should be made to Note 10 of the financial statements. Management is confident that the Company has the critical resources required for continued growth and can develop staffing and systems to support the requirements of the business.



RISK FACTORS

Technology and Competition

The Company's success depends on remaining competitive in the development of products, technologies and services in its area of expertise. Environmental technology is an evolving field in which new developments are expected to continue at a rapid pace. Competition in the water and wastewater treatment industry is intense and expected to increase, both from within the industry and from those diversifying into the field. Some of ZENON's competitors and potential competitors may have greater research, development, financial or personnel resources.

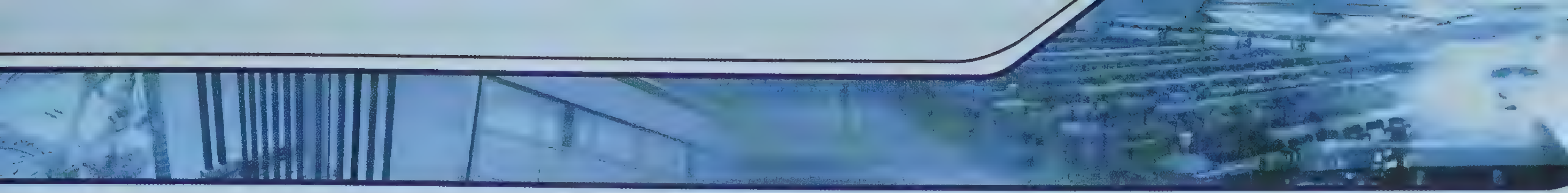
ZENON is subject to the risks generally associated with new product introductions and applications, including lack of market acceptance, delays in development and failure of products to operate properly. The market growth potential is subject to certain risks, including costs to develop and commercialize such products, the cost and feasibility of production, introduction of competing technologies, and market acceptance of the products and technologies involved. Also, the market place is demanding longer warranty periods. Although to date, there have been minimal warranty claims, there is an inherent risk to the Company in covering longer warranty periods.

Additional risk factors relating to technology and competition include:

- The success of ZENON's growth strategy, which is significantly dependent upon the success of ZeeWeed®;
- The development of products that may be similar to or perform the same function as ZeeWeed® by the Company's competitors;
- There can be no assurance that developments by others will not render the Company's products or technologies non-competitive or obsolete;
- The future success of the Company, which is dependent on the market for water and wastewater treatment continuing to accept membrane based solutions.

Mitigating risk factors with respect to ZENON's technology and the competition include the fact that the Company owns numerous patents securing its unique technology. In addition, continuing R&D has placed ZENON's technology ahead of the competition, thereby defining the Company as a global technology leader.

Olivenhain drinking water treatment plant - U.S.A.



Regulatory Requirements

Demand for some of ZENON's products and services is, to some degree, created by the enactment or enforcement of environmental regulations and standards affecting the Company's customers. Delays in the introduction of new regulations or less government enforcement action relating to existing regulations may result in a decrease in demand for these products and services.

In many jurisdictions, it will be necessary or desirable for the Company's products to receive certification or regulatory approval from the relevant authorities. Such certification or approval may not be granted or may not be achieved within the time anticipated by the Company. In certain jurisdictions, such certification or approval may be dependent upon political and other considerations not related to the performance or cost of the technology. As our product continues to be certified in new regions every year, the impact of this risk is lessened.

Municipal Water and Wastewater Business

A significant percentage of ZENON's revenue is derived from municipal customers. While municipalities represent an important part of the water and wastewater industry, contractor selection processes and funding for projects in the municipal sector entail certain additional risks not typically encountered with industrial and commercial customers.

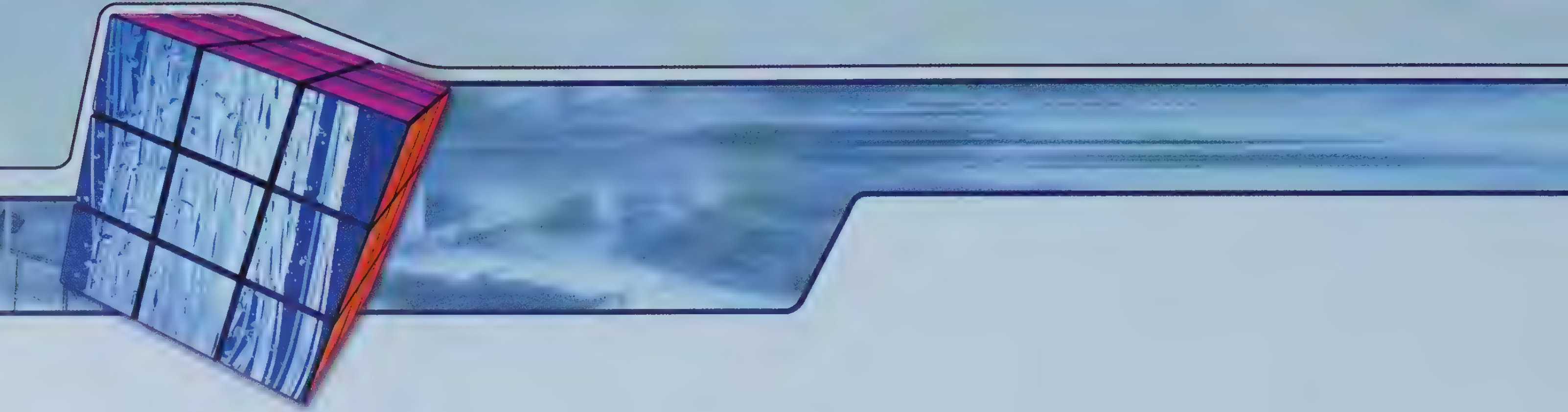
Competition for selection of a municipal contractor typically occurs through a formal bidding process that can require the commitment of greater resources and longer lead times than industrial projects. In addition, this segment is dependent upon the availability of funding at the local level, which may be the subject of increasing pressure as local governments are expected to bear a greater share of the cost of public services.

As the Company grows, it becomes less susceptible to delays in specific orders, which minimizes this risk.

Patents

Although a patent has a statutory presumption of validity, the issuance of which is not conclusive as to its validity or as to the enforceability of its claims. Moreover, the laws of certain countries may not protect proprietary rights to the same extent, as do the laws of Canada and the United States. Accordingly, there can be no assurance that the Company's patents will afford legal protection against competitors, nor can there be any assurance that the patents will not be infringed by others or that others will not obtain patents that the Company would need to license. Furthermore, successful challenges to certain of the Company's patents or trademarks could materially adversely affect its competitive and financial position.

Waikato drinking water treatment plant – New Zealand



There is no assurance that any of ZENON's pending or proposed patents covering its technologies will be granted. The costs of enforcing patent rights against infringers or defending against infringement charges by other patent holders may be significant.

Unpatented trade secrets, improvements, confidential know-how and continuing technological innovation are important to the Company's scientific and commercial success. The Company protects its proprietary information through reliance on trade secret laws and the use of confidentiality agreements with its corporate partners, collaborators, employees, consultants and other appropriate means. There can be no assurance these measures will prevent disclosure of the Company's proprietary information or that others will not develop independently or obtain access to the same or similar information or that the Company's competitive position will not be affected adversely thereby.

The continuing investment in R&D and the ongoing issuance of new patents spreads this risk over a growing information base, providing comfort that this risk is lessened.

Product Liability Claims

The Company faces the inherent risk of product failure and/or a product liability claim in respect of products that it produces or designs. A claim which is not covered by insurance or which exceeds the policy limit may materially adversely affect the operation and/or viability of the Company. To mitigate product liability risk, ZENON has substantial third party liability insurance in place.

Currency Exchange Risk

ZENON's operating results are reported in Canadian dollars, but a significant portion of its revenues and expenses are generated or incurred in U.S. dollars, the Euro and other foreign currencies. Significant long-term fluctuations in relative currency values may adversely affect the Company's consolidated results of operations.

The exchange rate between the Canadian dollar and foreign currencies has generally varied significantly over the past five years. To the extent that foreign currency revenues are greater than expenses in a strengthening foreign currency environment, there will be a positive impact on the Company's income from operations. Conversely, to the extent that the foreign currency revenues are greater than foreign currency expenses in a weakening foreign currency environment, there will be a negative impact on the Company's income from operations. In addition, the Company's costs of acquiring businesses or other assets in foreign currencies are fixed at the time of acquisition, which may expose the Company to fluctuations in exchange rates over time.

Where appropriate, ZENON does make use of derivative financial instruments to reduce exposure to fluctuations in foreign currency exchange rates. For further information on these derivative financial instruments, reference should be made to note 17(i) of the financial statements.

The Future

We are seeing an increase in the adoption of membrane technology worldwide. The combination of changing regulatory requirements and water quality and shortage concerns, are key drivers in the industry. Furthermore, ZENON's ongoing commitment to innovate and reduce the cost of the technology, will play an important role in the trend to move to membranes, particularly ZENON's ZeeWeed® technology.

The Company introduced the Homespring™ UF100 point of entry water filtration system in 2002. This product is unlike other home water filters and will position ZENON in a broader market, allowing the Company to grow in all areas of water filtration. The Homespring™ system uses ZeeWeed® membranes to filter out impurities and does not require frequent replacement. The market for this technology is expected to grow in the years to come as niche applications for the product expand.

ZENON is well positioned for future growth in the markets for membrane based water and wastewater treatment technology. The Company is also established as one of the key technology leaders in an industry expected to grow over the coming years. With a second membrane manufacturing plant in Hungary, completed before the end of 2002, there is sufficient manufacturing capacity in place, for current as well as future needs.

North American membrane manufacturing plant

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying financial statements of ZENON Environmental Inc. and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. Management has prepared the financial information presented elsewhere in the Annual Report and has ensured that it is consistent with that in the financial statements. ZENON Environmental Inc. endeavours to maintain systems of internal accounting and administrative controls of high quality, consistent with reasonable cost. Such systems are necessary to provide reasonable assurance that the financial information is relevant, reliable and accurate and that the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee meets periodically with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is properly discharging its responsibilities, and to review the Annual Report, the financial statements and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Committee also considers, for review by the Board and approval by the shareholders, the engagement or re-appointment of external auditors.

The Company's financial statements have been audited by Ernst & Young LLP, the external auditors, in accordance with generally accepted auditing standards on behalf of the shareholders. Ernst & Young LLP have full and free access to the Audit Committee.

Andrew Benedek
Chairman and
Chief Executive Officer

John E. Barker
Vice President Finance and
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of
ZENON Environmental Inc.

We have audited the consolidated balance sheets of ZENON Environmental Inc. as at December 31, 2002 and 2001 and the consolidated statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2002 and 2001 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants
Toronto, Canada

February 24, 2003

CONSOLIDATED BALANCE SHEETS

As at December 31

	2002 $	[000's]	2001 $
ASSETS *[note 7]*			
Current			
Cash and cash equivalents	**15,842**		5,517
Restricted cash	**688**		233
Accounts receivable *[notes 4 and 17[iv]]*	**32,754**		40,702
Accounts receivable - government funding *[note 14]*	**2,427**		2,786
Unbilled revenue *[note 17[iv]]*	**31,054**		20,678
Inventories *[note 3]*	**12,938**		8,788
Prepaid expenses and deposits	**3,192**		1,137
Future income taxes *[note 12]*	**1,733**		1,168
Total current assets	**100,628**		81,009
Capital assets, net *[note 5]*	**90,943**		52,087
Patents and other assets *[note 6]*	**13,191**		10,437
Goodwill *[note 2[i]]*	**4,506**		4,506
Future income taxes *[note 12]*	**1,393**		746
	210,661		148,785
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Bank indebtedness *[note 7]*	**—**		529
Accounts payable and accrued liabilities	**40,869**		34,880
Customer advances	**23,720**		14,597
Current portion of long-term debt *[note 8]*	**160**		171
Total current liabilities	**64,749**		50,177
Long-term debt *[note 8]*	**395**		10,270
Deferred technology credit *[notes 14 and 17[ii]]*	**5,000**		5,000
Total liabilities	**70,144**		65,447
Commitments and contingencies *[notes 10 and 14]*			
Shareholders' equity			
Capital stock *[note 9]*	**115,277**		72,049
Retained earnings	**20,250**		13,795
Cumulative translation adjustment *[note 15]*	**4,990**		(2,506)
Total shareholders' equity	**140,517**		83,338
	210,661		148,785

See accompanying notes

Approved by the Board of Directors:

Andrew Benedek
Chairman and Chief Executive Officer

Andrew Szonyi
Director

CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31

[All figures in $000's except earnings per share]	2002 $		2001 $
Revenue *[note 11]*	145,912		124,711
Cost of sales and services	94,190		76,787
Gross profit	51,722		47,924
Expenses			
Selling, general and administrative *[note 15]*	33,887		30,803
Amortization	9,921		8,172
Interest (income) expense, net *[note 8]*	(624)		2,038
	43,184		41,013
Operating income before income taxes	8,538		6,911
Provision for income taxes *[note 12]*	2,099		2,290
Net income for the year	6,439		4,621
Earnings per share *[note 13]*			
Basic	$0.24		$0.19
Diluted	$0.23		$0.19
Weighted average number of outstanding shares *[note 13]*			
Basic	26,944		23,883
Diluted	27,840		24,680

See accompanying notes

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

Years ended December 31

	2002 $	[000's]	2001 $
Retained earnings, beginning of year	13,795		9,254
Net income for the year	6,439		4,621
Interest on share purchase loans	96		—
Dividends on preference shares *[note 9a[i]]*	(80)		(80)
Retained earnings, end of year	20,250		13,795

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

	2002 $	[000's]	2001 $
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income for the year	**6,439**		4,621
Add (deduct) items not affecting cash			
Gain on disposal of assets	**(256)**		(620)
Recovery of write-down on share purchase loan	**(269)**		—
Amortization	**9,921**		8,172
Future tax provision	**(539)**		1,853
	15,296		14,026
Net change in non-cash working capital balances related to operations *[note 18]*	**8,028**		24,625
Cash flows provided by operating activities	**23,324**		38,651
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of capital assets	**(41,452)**		(16,824)
Proceeds on disposal of assets	**1,288**		3,000
Increase in patents and other assets	**(5,656)**		(6,127)
Decrease (Increase) in restricted cash	**(455)**		24
Cash flows used in investing activities	**(46,275)**		(19,927)
CASH FLOWS FROM FINANCING ACTIVITIES			
Issuance of common and non-voting Class A shares	**42,550**		—
Issue Cost	**(2,169)**		—
Repayment of long-term debt	**(10,020)**		(25)
Stock options exercised	**1,233**		2,316
Share purchase loan	**1,266**		—
Interest on share purchase loans	**96**		—
Proceeds from long-term debt	**143**		90
Proceeds from capital lease	**63**		—
Repayment of capital leases	**(73)**		(75)
Decrease in bank indebtedness	**(529)**		(24,491)
Increase in deferred technology credit	**—**		5,000
Cash flows provided by (used in) financing activities	**32,560**		(17,185)
Effect of exchange rate changes on cash	**716**		(225)
Net increase in cash during the year	**10,325**		1,314
Cash and cash equivalents, beginning of year	**5,517**		4,203
Cash and cash equivalents, end of year	**15,842**		5,517
Supplemental cash flow information			
Income taxes paid	**413**		433
Interest paid	**251**		2,393

See accompanying notes

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of the significant accounting policies of ZENON Environmental Inc. [the "Company"]. The Company is incorporated under the laws of the Province of Ontario. The Company is a leader in the manufacturing and use of membrane technology for water and wastewater treatment. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles.

[a] Principles of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany amounts and transactions have been eliminated upon consolidation.

[b] Revenue recognition

Revenue from significant contracts is recognized on the percentage-of-completion basis. Under this method, in the calculation of revenue and profit earned, greater weighting is given to value added activities undertaken by the Company that are critical to the completion of the contracts, such as design, fabrication, assembly and installation of membrane systems. Contract cancellations are reflected in revenue once certainty exists regarding their collectibility. During 2002, no revenue related to the cancellation of contractual arrangements was recorded [2001 - $2,921,000]. Revenue from all other contracts is recognized on the completed contract basis.

Although management uses its best estimates in determining contract revenue and costs, revisions in cost and profit estimates during the course of the contract can occur and are reflected in the period during which the need for the revision becomes known. Certain contracts contain penalty provisions based on performance relative to established targets. Such penalties are included in cost estimates when such amounts become effective and can be reasonably determined. Pre-contract direct selling costs such as bid and proposal costs are expensed as incurred. Only once the contract has been awarded are contract costs deferred and included in the percentage-of-completion calculations. For contracts where revenue is recognized on the percentage-of-completion basis, in situations where contract costs and related profit margins are in excess of amounts billed, these amounts are included in the caption unbilled revenue on the consolidated balance sheets. Where amounts billed are in excess of contract costs and related profit margins, then these amounts are included in customer advances.

Revenue from maintenance contracts is recognized on a straight-line basis over the term of the contract.

When the Company enters into distribution agreements, revenue from such agreements is recognized when the agreement is executed. Generally, these agreements do not commit the Company to any future obligations. Where such future obligations do exist, the Company defers revenue to cover these future obligations.

[c] Warranty

Provisions for future warranty costs are made at the time the related revenue is recorded.

[d] Cash and cash equivalents

All liquid investments with original maturities of three months or less are classified as cash and cash equivalents and are recorded at cost.

[e] Inventories

Raw materials are stated at the lower of cost and replacement cost. Work in process and finished goods are stated at the lower of cost and net realizable value. Cost is generally determined on a first-in, first-out basis.

[f] Capital assets

Capital assets are recorded at cost less related investment tax credits and government grants. Amortization is recorded using the straight-line method principally over the following periods:

Buildings	40 years
Machinery and equipment	3 - 8 years
Furniture and fixtures	5 - 8 years
Computer equipment and software	3 - 7 years
Automobiles	5 years

Interest incurred on debt related to the buildings under construction is included in the cost of such assets.

[g] Research and development costs

Research and development costs are expensed in the year in which they are incurred, except when development costs meet the criteria for deferral. Deferred product development costs are amortized on a straight-line basis over periods ranging from 3 to 5 years.

[h] Government incentives

Non-repayable government incentives are accounted for using the cost reduction method whereby the incentives relating to current expenditures are deducted from the related expenditures and those relating to capital expenditures are applied to reduce the cost of the asset acquired. Government incentives with fixed repayment amounts are included on the consolidated balance sheets under the caption of deferred technology credit.

[i] Patents and other assets

Patent costs, which consist of legal and application fees are amortized on a straight-line basis over the life of the patent generally not exceeding 17 years. Included in other assets are deferred product development costs which are amortized on a straight-line basis over periods not exceeding 5 years. Pre-operating costs associated with the commencement of new operations, such as new manufacturing facilities or the expansion of the Company's international service and sales network, are deferred until the new location is capable of commercial operations. Such costs are amortized on a straight-line basis over 3 years commencing with the date on which the new operation is capable of commercial operations. The recoverability of these costs is reviewed on an annual basis.

[j] Goodwill

Goodwill represents the excess of the purchase price of businesses acquired over the fair value of the net assets acquired. Effective January 1, 2002 the Company adopted the Canadian Institute of Chartered Accountant's new recommendation for the measurement, presentation and disclosure of goodwill. The most significant change is that goodwill is no longer subjected to amortization but is subjected to an annual assessment for impairment by applying a fair value test. Any impairment in the value of goodwill would be charged to earnings. Prior to January 1, 2002 goodwill was being amortized over a period of 10 – 40 years.

[k] Income taxes

The Company follows the liability method of tax allocation in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

[l] Stock-based compensation plan

The Company has a stock-based compensation plan, which is described in note 9[b]. No compensation expense is recognized when stock options are issued to employees, however, pro-forma disclosure of net income and net income per share is provided as if these awards were accounted for using the fair value method. Consideration received on the exercise of stock options is credited to capital stock.

[m] Foreign currency translation

Revenue and expenses of self-sustaining foreign operations are translated into Canadian dollars at the average rates of exchange during the years. The assets and liabilities of such operations are translated at year-end rates. The resulting gain or loss on translation is recorded in shareholders' equity as a cumulative translation adjustment.

Transactions of Canadian operations denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at the date of the transaction. Monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the consolidated balance sheet dates and the resulting exchange gain or loss is included in income.

Gains or losses on non-hedged exposures related to long-term monetary items will be reflected in the net income for the period.

The Company uses foreign currency derivative financial instruments, such as forward contracts and options, to manage the effects of exchange rate changes on foreign currency exposures on anticipated foreign denominated sales and raw material and equipment purchases. The Company does not hold or use any derivative instruments for speculative trading purposes. Items hedged by foreign currency contracts are translated at contract rates and gains and losses on these are recognized as an adjustment of the revenues, of the cost of sales and of the fixed assets respectively when the transaction is recorded.

The Company documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The process includes linking all derivatives to specific assets and liabilities or to specific firm commitments or forecasted transactions.

Realized and unrealized gains or losses associated with derivative instruments, which have been terminated or cease to be effective prior to maturity, are deferred under other current or non-current assets or liabilities on the balance sheet and recognized as a component of the related transaction in the period in which the related transaction is recognized.

[n] Earnings per share

Basic earnings per share is determined by dividing net income by the weighted average number of common and non-voting Class A shares outstanding in each respective period. The Company employs the treasury stock method when computing diluted earnings per share. Under the treasury stock method, the exercise of options is assumed to have taken place at the beginning of the period [or at the time of issuance, if later]. The proceeds from the exercise are assumed to be used to purchase common stock at the average market price during the period. The incremental shares [the difference between the number of shares assumed issued and the number of shares assumed purchased] are included in the denominator of the diluted earnings per share calculation.

[o] Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Management believes that the estimates utilized in preparing its consolidated financial statements are reasonable and prudent; however, actual results could differ from those estimates.

2. CHANGES IN ACCOUNTING POLICIES

[i] The Canadian Institute of Chartered Accountants [CICA] has issued new accounting recommendations for the measurement, presentation and disclosure of goodwill. The Company adopted these recommendations effective January 1, 2002 as permitted by the CICA Handbook, Section 3062 as described in note 1[j]. Accordingly, goodwill is no longer amortized. If goodwill amortization had not been recorded throughout last year, the net income for 2001 would have increased by $279,000 and would have increased the basic and diluted earnings per share by $0.02 and $0.01 respectively. The Company performed the required transitional tests of goodwill as of June 30, 2002 and determined that the existing goodwill is not impaired.

[ii] Effective January 1, 2002, the Company adopted the recommendations in Handbook, Section 3870, Stock-based compensation and other stock based payments, issued by CICA as described in note 1[l]. The new recommendations are applicable only to awards granted by the Company after date of adoption.

[iii] Effective January 1, 2002, the Company adopted the recommendations in Handbook, Section 1650, Foreign Currency Translation relating to the recognition in income of the foreign exchange impact of long-term monetary items. There was no significant impact on the financial statements from adopting this accounting policy.

3. INVENTORIES

Inventories consist of the following:

	2002		2001
	$	[000's]	$
Raw materials	**5,594**		3,704
Work in process	**3,408**		2,952
Finished goods	**3,936**		2,132
	12,938		8,788

4. RELATED PARTIES

As at December 31, 2001, a promissory demand loan of $765,000 bearing interest at prime plus 0.50% [year end rate 4.5%] was due from an officer of the Company. The promissory demand loan was repaid in 2002.

5. CAPITAL ASSETS

Capital assets are as shown in the table below:

Capital Assets 2002 [$000's]	**Cost**	**Accumulated amortization**	**Net book value**
Land	**6,441**	—	**6,441**
Buildings	**36,189**	**1,758**	**34,431**
Machinery and equipment	**57,476**	**17,858**	**39,618**
Furniture and fixtures	**3,598**	**1,890**	**1,708**
Computer equipment and software	**7,468**	**5,278**	**2,190**
Automobiles	**488**	**312**	**176**
Assets under construction or development	**6,379**	—	**6,379**
	118,039	**27,096**	**90,943**

Capital Assets 2001 [$000's]	Cost	Accumulated amortization	Net book value
Land	5,029	—	5,029
Buildings	20,462	1,183	19,279
Machinery and equipment	28,620	12,864	15,756
Furniture and fixtures	2,913	1,657	1,256
Computer equipment and software	5,966	4,391	1,575
Automobiles	425	266	159
Assets under construction or development	9,033	—	9,033
	72,448	20,361	52,087

6. PATENTS AND OTHER ASSETS

Patents and other assets consist of the following:

Patents and other assets 2002 [$000's]	**Cost**	**Accumulated amortization**	**Net book value**
Patents	**4,889**	**1,650**	**3,239**
Deferred product development cost	**9,367**	**2,468**	**6,899**
Pre-operating costs and other	**4,738**	**1,685**	**3,053**
	18,994	**5,803**	**13,191**

Patents and other assets 2001 [$000's]	Cost	Accumulated amortization	Net book value
Patents	4,347	1,300	3,047
Deferred product development cost	10,284	3,895	6,389
Pre-operating costs and other	2,561	1,560	1,001
	17,192	6,755	10,437

7. BANK CREDIT FACILITIES

In fiscal 2002, the Company and its subsidiaries entered into new agreements with certain of its bankers which, together with existing agreements, provide credit facilities which total $107.2 million. These facilities are made up as follows:

	2002 $	[000's]	2001 $
364-day committed extendable operating credit facility	**40,000**		—
Demand facility	**7,900**		49,300
Revolving term facility [note 8]	**300**		15,300
Letter of credit facility [note 10[ii]]	**43,000**		36,800
Foreign exchange hedging facility [margin availability]	**16,000**		15,500
Revolving project finance demand facility	**—**		1,700
	107,200		118,600

Of these facilities at December 31, 2002, no amounts were utilized on the revolving project finance demand facility [2001 - nil], the demand facility [2001 – nil], the revolving term facility [2001 – approximately $10 million] or the 364-day committed extendible operating credit facility. Approximately $9.5 million of the available foreign exchange contract margin of $16 million was utilized [2001 - approximately $4.7 million]. The borrowings are limited to available margin on eligible accounts receivable, inventory and contract balances and can be accessed in either Canadian or U.S. dollars. As collateral for these facilities, the Company has provided a general security agreement having a first priority security in personal property of the Company, including receivables, inventory and equipment and machinery. The demand facilities bears interest at the Company's banker's prime rate [2001 - banker's prime rate plus 0.15% - 0.50%] for either Canadian or U.S. dollar loans. The weighted average interest rate of the bank indebtedness in fiscal 2002 was approximately 5.35% [2001 – 6.9%]. The banking agreements are subject to certain restrictive financial covenants.

8. LONG-TERM DEBT

Long-term debt consists of the following:

	2002		2001
	$	[000's]	$
Revolving term facility maturing in June 2006, with principal repayable in the amount of $2 million annually commencing in June 2002, plus interest at the bank's prime rate plus 0.75% [2001 - banker's prime rate plus 1.25%] *[note 7]*	—		10,000
Obligations under capital leases	**173**		182
Government interest-free loan repayable in the amount of $14 quarterly until June 2005 [loan denominated in Hungarian Forints]	**142**		162
Government interest-free loan to be repayable as follows: October 2005 - $108, September 2006 - $132 [loan denominated in Hungarian Forints]	**240**		97
	555		10,441
Less current portion	**160**		171
	395		10,270

The aggregate annual principal repayments required in respect of long-term debt are as follows:

	$ [000's]
2003	160
2004	127
2005	136
2006	132
	555

Interest expense on long-term debt during the year amounted to approximately $69,000 [2001 - $745,000].

9. CAPITAL STOCK

[a] Share capital

The Company is authorized to issue an unlimited number of common shares, an unlimited number of non-voting, convertible, participating Class A shares and 300,000, 2% cumulative, redeemable, convertible, voting Series 1 preference shares.

The following details the changes in the issued common shares, non-voting Class A shares and the Series 1 preference shares for the two years ended December 31.

Common Shares	**Number**	**$** [000's]
Balance as at January 1, 2001	19,795,642	19,585
Exercise of Options	618,110	2,316
Balance as at December 31, 2001	20,413,752	21,901
Public offering [ii]	1,000,000	16,652
Exercise of options	153,238	1,155
Shares cancelled [iii]	(7,794,584)	(105,149)
Shares issued [iii]	7,794,584	105,149
Balance as at December 31, 2002	21,566,990	39,708

Non-voting Class A Shares	**Number**	**$** [000's]
Balance as at January 1, 2001 and December 31, 2001	3,900,000	47,859
Public offering [ii]	2,000,000	24,403
Exercise of options	11,000	77
	5,911,000	72,339
Share purchase loan receivable [iv]	(70,000)	(770)
[2001 – 180,000 shares - $1,711]		
Balance as at December 31, 2002	5,841,000	71,569

Series 1 preference shares	**Number**	**$** [000's]
Balance at January 1, 2001, December 31, 2001 and 2002	300,000	4,000

[i] The non-voting Class A shares are convertible into common shares on a share-for-share basis on June 10, 2008. Except with respect to voting and rights of conversion, the non-voting Class A shares have the same rights and are equal in all respects to common shares on a share-for-share basis. The Series 1 preference shares are redeemable at the Company's option for $13.33 per share plus any unpaid dividends. The Series 1 preference shares are convertible into common shares at any time at a conversion price equal to the weighted average trading price for the common shares during the five-day trading period immediately prior to conversion. As at December 31, 2002, there remains $400,000 of dividends payable related to the Series 1 preference shares. This amounts to approximately $1.33 per Series 1 preference share.

[ii] During 2002, the Company completed the sale of 2,000,000 non-voting Class A shares and 1,000,000 common shares. The aggregate proceeds were $42,549,999. Underwriters commission and offer expenses totalled $2,169,299. A future tax asset of $673,737 was recorded on this transaction.

[iii] During 2002, the Company purchased from and issued to an officer and shareholder of the Company an equivalent number of common shares. This transaction, which was subject to regulatory approval, was reviewed and approved by the Board.

[iv] During 2002, all the loans to former employees that were made for the purpose of purchasing non-voting Class A shares were repaid. The outstanding loan receivable from current employees relating to the purchase of non-voting Class A shares is $770,000. The average purchase price of the non-voting Class A shares was $11.00. The current employees have provided the shares as collateral for these loans. The market value of the non-voting Class A shares as at December 31, 2002 was $10.90.

During 2001, the Company amended the terms of the loans [note 17[ii]] of the current employees by extending the repayment terms and interest-free period. The loans are interest-free until July 31, 2003 and bear interest at the bank's prime rate of interest thereafter. The loans are repayable in four annual equal installments of principal plus accrued interest commencing on July 31, 2004 and ending July 31, 2007.

[b] Stock options

Under the terms of the Company's stock option plan, options may be granted in an aggregate of up to but not exceeding 2,600,000 authorized but unissued common shares and up to but not exceeding 280,000 non-voting Class A shares. The period during which an option is exercisable varies to a maximum not exceeding ten years from the date the option is granted. The vesting period of the options varies from zero to five years.

[i] A summary of the status of the Company's stock option plan for common shares as at December 31, 2002 and 2001 and the changes during the years then ended are as follows:

	2002		2001	
	Number of shares #	**Weighted average exercise price $**	Number of shares #	Weighted average exercise price $
Options outstanding, beginning of year	**844,378**	**8.82**	1,315,252	6.32
Granted during the year	**158,524**	**18.38**	149,000	9.91
Exercised during the year	**(153,238)**	**7.54**	(618,110)	3.75
Cancelled/forfeited during the year	**(6,400)**	**8.60**	(1,764)	4.74
Options outstanding, end of year	**843,264**	**10.85**	844,378	8.82
Options exercisable, end of year	**580,159**		523,558	

As at December 31, 2002, the common share stock options outstanding were as follows:

Range of exercise prices $	Number outstanding #	Options outstanding: Remaining contractual life [years]	Options outstanding: Weighted average exercise price $	Options exercisable: Number exercisable #	Options exercisable: Weighted average exercise price $
5.900 to 8.750	335,400	2.56 years	7.55	191,300	7.27
9.250 to 11.625	284,840	0.57 years	9.91	284,520	9.91
13.180 to 14.650	59,500	5.65 years	13.51	53,875	13.45
15.000 to 19.000	163,524	9.29 years	18.29	50,464	17.20
	843,264			580,159	

[ii] A summary of the status of the Company's stock option plan for non-voting Class A shares as at December 31, 2002 and 2001 and the changes during the years then ended are as follows:

	2002 Number of shares #	2002 Weighted average exercise price $	2001 Number of shares #	2001 Weighted average exercise price $
Options outstanding, beginning of year	**199,600**	**11.42**	190,100	12.18
Granted during the year	—	—	20,000	4.90
Exercised during the year	**(11,000)**	**7.04**	—	—
Cancelled/forfeited during the year	—	—	(10,500)	12.75
Options outstanding, end of year	**188,600**	**11.68**	199,600	11.42
Options exercisable, end of year	**140,880**		114,160	

As at December 31, 2002, the non-voting Class A share stock options outstanding were as follows:

Range of exercise prices $	Number outstanding #	Options outstanding: Remaining contractual life [years]	Options outstanding: Weighted average exercise price $	Options exercisable: Number exercisable #	Options exercisable: Weighted average exercise price $
4.90	12,000	3.3 years	4.90	—	4.90
7.35	20,000	1.8 years	7.35	16,000	7.35
12.75	156,600	1.6 years	12.75	124,880	12.75
	188,600			140,880	

[iii] Compensation expense

The Company does not recognize compensation when stock options are granted to employees and directors under the stock option plan. The table below presents pro-forma net income and basic and diluted income per common share as if stock options granted to employees and directors had been determined based on the fair value method. This table includes all stock options granted by the Company during the year ended December 31, 2002.

Stock Options Granted [All figures in $000's except earnings per share]	**2002**
Income for the year	**6,439**
Compensation expense	**399**
Pro-forma income for the year	**6,040**
Basic income per share	
As reported	**$0.24**
Pro-forma	**$0.22**
Diluted income per share	
As reported	**$0.23**
Pro-forma	**$0.22**

The fair value of the options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk-free interest rate of 5%, dividend yields of 0%, volatility of 58.9% and expected option life of 5 years.

The weighted average grant date fair value of the stock options granted was $10.10.

10. COMMITMENTS AND CONTINGENCIES

[i] The Company is committed to future minimum annual lease payments under various operating leases as follows:

	Real property $	**Equipment** $	**Total** $
		[000's]	
2003	305	1,602	1,907
2004	202	1,287	1,489
2005	144	945	1,089
2006	82	742	824
2007	53	625	678
	786	5,201	5,987

[ii] The Company provides certain warranties on its products and services. At December 31, 2002, a liability of $5.6 million for future warranty costs, based on past experience and management's best estimates, has been included in accounts payable and accrued liabilities [2001 - $3.3 million]. In addition, the Company has performance bonds and letters of credit outstanding under product manufacturing and service contracts totalling approximately $52.2 million [2001 - approximately $32.8 million] and $21.1 million [2001 - approximately $15.9 million], respectively. These performance bonds and letters of credit expire on various dates within two years.

[iii] As at December 31, 2002, the Company is committed to capital asset purchases of approximately $2.5 million [2001 - $0.7 million].

[iv] From time to time the Company is subject to claims and lawsuits arising in the ordinary course of operations. In the opinion of management, the ultimate resolution of such pending legal proceedings will not have a material effect on the Company's consolidated financial position.

11. REVENUE

During 2002, revenue of $1,227,610 was recorded that related to distribution agreements that allow distributors to assemble water and wastewater treatment systems using the Company's proprietary immersed membrane technology [2001 - $2,926,000].

12. INCOME TAXES

[i] Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for income tax purposes. Significant components of the Company's future income tax assets and liabilities are as follows:

	2002		2001
	$	[000's]	$
Assets			
Non-deductible reserves	1,522		923
Undeducted scientific research and experimental development expenses	1,588		1,746
Undeducted financing costs	622		245
Tax benefit of investment tax credits	1,494		430
	5,226		3,344
Liabilities			
Capital assets	(1,155)		(411)
Other assets	(945)		(1,019)
	(2,100)		(1,430)
Total future income taxes	3,126		1,914
Future income taxes - current	1,733		1,168
Future income taxes - long-term	1,393		746
	3,126		1,914

[ii] The details of the provision for income taxes are as follows:

	2002		2001
	$	[000's]	$
Current provision			
Current income taxes	1,423		1,175
Reduction in income tax expense from previously unrecognized tax loss	(390)		(841)
Federal large corporations tax	220		185
Other	(157)		(82)
	1,096		437
Future provision			
Future income taxes	1,003		1,853
	1,003		1,853
Total provision for income taxes	2,099		2,290

[iii] The provision for income taxes differs from the amounts which would be obtained by applying Canadian statutory rates to operating income before income taxes. The differences result from the following items:

	2002 $	[000's]	2001 $
Canadian statutory income tax rate	**38.62%**		41.87%
Provision for income taxes at Canadian statutory rates	**3,296**		2,893
Manufacturing and processing profits deduction	**(311)**		(363)
Foreign income tax differential	**(1,882)**		107
Federal large corporations tax	**220**		185
Future income tax assets not previously recognized	**(136)**		(1,210)
Current year losses not recognized	**641**		252
Other	**271**		426
Total provision for income taxes	**2,099**		2,290

[iv] The Company has unclaimed deductions for tax purposes and tax loss carryforwards of approximately $5.5 million [2001 - $3.6 million] for which no benefit has been recorded in the accounts. The estimated after-tax value of these attributes is approximately $1.6 million [2001 - $1.5 million]. Of these aggregate amounts, $2.2 million will start to expire in 2008 and the remainder has no expiry date. In addition, the Company has investment tax credits of approximately $1.0 million for which no benefit has been recorded in the accounts. These credits may be applied against future income taxes payable. The rights to claim these credits expire in varying amounts in 2009 and 2010.

[v] The Company has not provided for withholding tax on unremitted retained earnings of foreign subsidiaries as such earnings are expected to remain permanently invested.

13. EARNINGS PER SHARE

[All figures in $000's except earnings per share]	2002 $		2001 $
Net income available to common shareholders	**6,439**		4,621
Denominator for basic earnings per common share Weighted average of outstanding shares	**26,994**		23,883
Effect of dilutive stock options and preference shares	**846**		797
Denominator for diluted earnings per common share Adjusted weighted average of outstanding shares	**27,840**		24,680
Earnings per common share – basic	**$0.24**		$0.19
Earnings per common share – diluted	**$0.23**		$0.19

14. RESEARCH AND DEVELOPMENT COSTS

During the year, the Company incurred approximately $8,232,000 [2001 - $6,920,000] in research and development costs.

The Company has an agreement with Technology Partnerships Canada ["TPC"] whereby TPC will provide up to a maximum of approximately $9.9 million for a specific research contract. As at December 31, 2002 approximately $9.8 million has been claimed from this agreement of which approximately $4.8 million was deducted from other assets, while $5.0 million was reflected on the consolidated balance sheet under the caption deferred technology credit as this relates to the minimum royalty repayment as per the agreement. Of the $9.8 million claimed approximately $7.7 million [2001 - approximately $3.5 million] has been received while the remaining amount of approximately $2.1 million [2001 - $2.7 million] is reflected as accounts receivable. If certain aspects of this project are successful, the Company is obligated to pay to TPC a royalty based on the total unconsolidated revenue of the Company. The agreement contemplates that this royalty will have both a minimum and maximum amount.

During 2002, other than TPC, total incentives under various government programs and from other sources in respect of certain qualifying expenditures amounted to approximately $865,000 [2001 - $1,282,000] which have been applied against the related cost.

Repayment of certain incentives received in the current and prior years is required if the research and development results in marketable products. If this occurs, the repayment is in the form of a royalty based on a percentage of the resulting sales revenue for a fixed period of time. Such royalties are charged to income when incurred.

The Company is also entitled to receive an investment tax credit for qualifying research and development costs incurred.

15. FOREIGN EXCHANGE GAINS/LOSSES

Included in selling, general and administrative expense is a foreign exchange gain of $345,000 [2001 – foreign exchange loss of $76,000].

In 2002, the capital expenditures in Hungary combined with foreign exchange fluctuations in the Hungarian Forint has contributed significantly to the change in the cumulative translation adjustment.

16. SEGMENTED INFORMATION

The Company operates in Canada, United States, Europe and the Middle East, in the water treatment industry. Its reportable operating segments are strategic business units that offer membrane based systems for water and wastewater treatment. These segments are managed separately as each business unit requires a different market strategy.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company accounts for intersegment sales at agreed upon prices which recognizes the research and development costs incurred in the development of membranes.

Operations and identifiable assets by operating segment are presented below. External sales are allocated on the basis of sales to external customers.

Operating Segments

[000's]	Technology, membranes and corporate 2002 $	Technology, membranes and corporate 2001 $	Systems – North America 2002 $	Systems – North America 2001 $	Systems – Europe, Asia and Middle East 2002 $	Systems – Europe, Asia and Middle East 2001 $	Total 2002 $	Total 2001 $
Revenue from external customers	**2,032**	243	**106,906**	94,800	**36,974**	29,668	**145,912**	124,711
Intersegment revenue	**31,608**	28,199	**879**	1,313	**1,276**	485	**33,763**	29,997
Amortization of capital assets [1]	**5,747**	3,783	**3,085**	3,373	**1,089**	1,016	**9,921**	8,172
Segment income (loss) before interest and taxes	**(4,080)**	(2,095)	**9,038**	7,779	**2,935**	3,646	**7,893**	9,330
Total assets	**151,205**	97,449	**49,815**	42,558	**9,641**	8,778	**210,661**	148,785
Capital assets expenditures [1]	**39,229**	15,224	**5,203**	2,737	**1,773**	2,610	**46,205**	20,571

Reconciliation of Income

[000's]	2002 $	2001 $
Total income before interest and taxes for reportable segments	**7,893**	9,330
Elimination of intersegment profit	**21**	(381)
Interest, net	**624**	(2,038)
Provision for income taxes	**(2,099)**	(2,290)
Net income for the year	**6,439**	4,621

External sales and capital assets by jurisdiction are presentd below:

[000's]	Canada 2002 $	Canada 2001 $	United States 2002 $	United States 2001 $	Europe, Asia and Middle East 2002 $	Europe, Asia and Middle East 2001 $	Total 2002 $	Total 2001 $
External sales	**30,502**	41,328	**76,630**	53,715	**38,780**	29,668	**145,912**	124,711
Capital assets [1]	**67,893**	60,356	**730**	1,147	**40,017**	5,527	**108,640**	67,030

[1] Includes patents, goodwill and other assets

17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

[i] The Company enters into either forward foreign exchange contracts or foreign exchange options to sell specific amounts of U.S. dollars to Canadian dollars and Euros to Canadian dollars at set future dates at predetermined exchange rates. The contracts are matched with anticipated U.S. dollar and Euro cash flows. The Company enters into the forward foreign exchange contracts to protect itself from the possibility of loss should the value of the U.S. dollar or Euro decline relative to the Canadian dollar.

The amount of anticipated future export sales receipts in U.S. dollars are projected in light of current conditions in the Company's market in the U.S., existing orders from customers and the Company's past experience in similar circumstances. Management has set a risk management objective of hedging all significant U.S. dollar denominated sales and specific Euro denominated sales at the time certainty of the contract award exists.

As at December 31, 2002, the terms of these contracts will result in the Company selling $43.6 million USD [2001 - $29.3 million USD] at a weighted average exchange rate of 1.575 [2001 – 1.594] Canadian and 4.2 million Euros [2001 – nil] at a weighted exchange rate of 1.565 Canadian. The settlement dates of these contracts do not exceed 15 months.

The unrecognized loss on hedges of anticipated U.S. dollar and Euro cash flows was approximately $1,007,000 [2001 – unrecognized loss of approximately $222,000].

[ii] The Company's estimate of the fair value of other financial instruments which includes receivables, unbilled revenue, loans receivable, payables, long-term debt and interest-free government loans approximates their carrying value, except for loans receivable. The fair market value of these loans for present employees at December 31, 2001, using a 5% discount rate, is $738,000. The fair market value of the deferred technology credit using a 5% discount rate is $3,806,000.

[iii] The concentration of credit risk in accounts receivable is limited due to the Company's large customer base, geographic dispersion of its customers and deposits received from customers. In addition, in its largest business sector the Company deals with various levels of government where the risk of credit loss is less than with the private sector. Certain of the Company's projects in the government sector can be subject to delays due to the timing of the customers' funding arrangements. Many projects in excess of $1.0 million are secured with material and labour payment bonds/performance bonds or letters of credit.

[iv] While the Company has many customers, one customer represents 14% of the accounts receivable balance while another customer represents 11% of the unbilled revenue as at December 31, 2002. [As at December 31, 2001, one customer represented 12% of the accounts receivable balance while two other customers represent 38% of the unbilled revenue.]

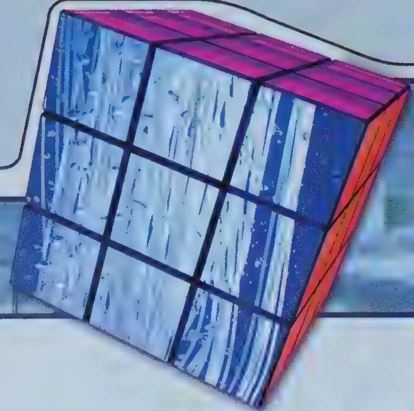
18. CONSOLIDATED STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations consists of the following:

	2002		2001
	$	[000's]	$
Accounts receivable	**9,588**		(2,584)
Unbilled revenue	**(9,993)**		7,509
Inventories	**(4,155)**		(1,752)
Prepaid expenses and deposits	**(2,027)**		(307)
Accounts payable and accrued liabilities	**5,943**		12,273
Customer advances	**8,672**		9,486
	8,028		24,625

19. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2002 consolidated financial statements.



10-YEAR HISTORICAL REVIEW

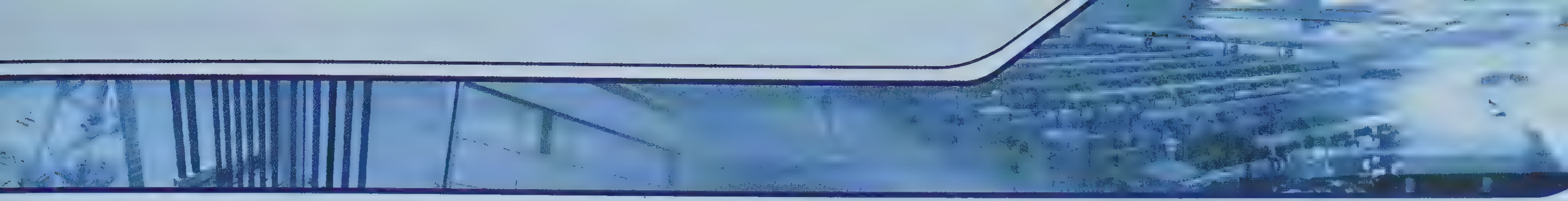
Years ended December 31 ($000's except earnings per share)

	2002	2001	2000
Operating Results			
Revenue	**145,912**	124,711	84,476
Gross profit	**51,722**	47,924	28,100
Percent	**35.4%**	38.4%	33.3%
Net income (loss)	**6,439**	4,621	2,895
Cash flow from (used in) operations	**23,324**	38,651	(4,323)
Financial Position			
Cash	**15,842**	5,517	4,203
Current assets	**100,628**	81,009	81,867
Current liabilities	**64,749**	50,177	53,308
Working capital	**35,879**	30,832	28,559
Capital assets	**90,943**	52,087	43,265
Current bank indebtedness	**0.0**	529	25,020
Long-term debt	**555**	10,441	10,451
Shareholders' equity	**140,517**	83,338	76,061
Per Share Data*			
Net earnings per share			
Basic	**0.24**	0.19	0.12
Diluted	**0.23**	0.19	0.12
Market value - common shares (ZEN)			
- High	**21.25**	17.15	12.50
- Low	**12.05**	6.90	5.60
- Close December 31	**14.75**	16.46	7.25
Market value - non-voting Class A shares (ZEN.A)**			
- High	**16.99**	12.99	10.00
- Low	**8.70**	3.80	3.25
- Close December 31	**10.90**	12.00	3.90
Other			
Total number of employees	**859**	634	501
Number of employees in R&D	**53**	54	49
Weighted average outstanding shares***	**26,994**	23,883	20,415

* reflects 2-for-1 share split, rounded to nearest cent

** convertible into common shares on a share-for-share basis on June 10, 2008

*** reflects 2-for-1 share split



1999	1998	1997	1996	1995	1994	1993
98,755	77,211	58,428	53,151	40,127	47,667	40,204
35,147	29,944	21,493	17,489	14,038	14,441	15,348
35.6%	38.8%	36.8%	32.9%	35.0%	30.3%	38.2%
2,464	4,789	1,656	1,451	(8,438)	456	114
(6,479)	(3,509)	384	1,521	(1,361)	1,593	(923)
8,676	12,752	2,074	1,593	2,453	4,233	5,215
66,326	54,961	29,235	25,750	23,850	26,927	23,268
26,789	22,249	23,264	19,816	19,765	15,617	11,213
39,537	32,712	5,971	5,934	4,085	11,310	12,055
28,622	11,234	8,912	5,959	9,629	9,248	7,063
5,673	1,967	5,739	3,628	3,894	3,412	2,084
7,830	4,973	5,698	637	4,404	5,626	2,539
73,558	54,916	21,423	15,485	13,391	17,842	16,950
0.11	0.23	0.09	0.08	(0.51)	0.03	0.01
0.10	0.22	0.08	0.08	(0.51)	0.03	0.01
20.50	14.43	8.15	4.95	4.15	6.20	6.20
7.50	6.75	4.13	1.30	2.03	2.80	2.70
12.00	13.25	7.13	4.90	2.45	4.15	5.35
18.30	13.00	--	--	--	--	--
6.50	8.38	--	--	--	--	--
11.00	13.00	--	--	--	--	--
464	375	298	310	240	360	353
36	34	13	13	12	14	14
23,007	10,344	9,701	9,559	7,436	8,274	8,272

BOARD OF DIRECTORS

1. Andrew Benedek, Chairman of the Board and Chief Executive Officer of ZENON. He founded the company in 1980 with a vision of a world where cost effective membrane technology could ensure humanity's survival by providing safe, and superior quality water.

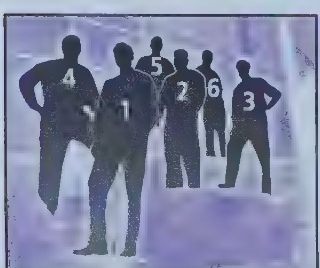
2. John A. Coburn, prior to his retirement in June 2002, was a former Senior Vice President at ZENON. During his 20-year career with the Company, he served in virtually all of its major operating areas, and upon his retirement, was acknowledged as one of ZENON's key architects.

3. David Colcleugh, prior to his retirement in January 2003, was the Chairman, President and Chief Executive Officer of DuPont Canada Inc. Currently Mr. Colcleugh retains the position of Chairman of the Board of DuPont Canada Inc. ● ▲

4. The Honourable Frank McKenna is a Senior Partner with McInnes Cooper, Barristers and Solicitors in Atlantic Canada. He was the Premier of New Brunswick from 1987 to 1997. ■

5. Andrew Szonyi is Executive Vice President and Partner in First Nations Equity Inc., an Aboriginal investment banking firm. Mr. Szonyi has extensive experience as a financial and management consultant and is a corporate director of several public and private corporations. ● ■ ▲

6. Samir Zalzal, prior to his retirement in March 2000, was the President and Chief Executive Officer of Ingersoll-Rand Canada Inc. An independant business consultant and active supporter of numerous industrial associations, Mr. Zalzal is also the founding member and President of the Canada-Arab Business Council and the Iran-Canada Business Council. ● ▲



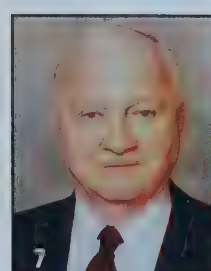
Committee Memberships

● Audit Committee

■ Corporate Governance and Nominating Committee

▲ Human Resources Committee

7. The Honourable Maurice Strong is Special Advisor to the Secretary General of the United Nations. He is internationally recognized for his leadership in the international environmental movement, including as organizer of the United Nations Conference on Environment and Development in 1992 (Earth Summit). ■



CORPORATE INFORMATION

SENIOR OFFICERS

Andrew Benedek
Chairman of the Board and Chief Executive Officer

Rafael Simon
Chief Operating Officer

John E. Barker
Chief Financial Officer

Pierre Côté
Chief Technology Officer

Ian Crossley
Chief Engineer

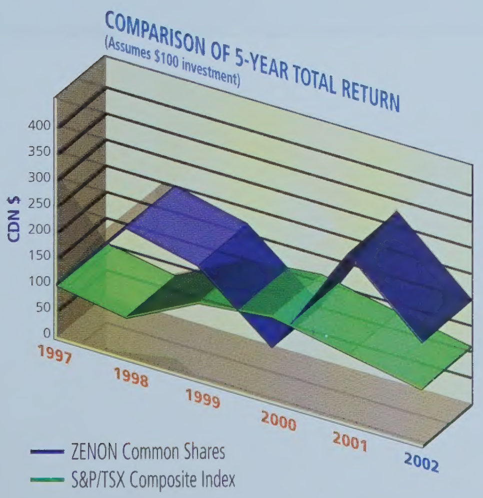
Upen Bharwada
Vice President, Business Development

Bill Bonkoski
Vice President, Industrial Systems

Diana Mourato
Vice President, International

Steve Watzeck
Vice President, Municipal Systems

Daryl Wilson
Vice President, Manufacturing



SHAREHOLDER INFORMATION

Shareholders who need information on transferring shares, lost certificates, change of address, or cancelling duplicate mailings, should contact ZENON's transfer agent, CIBC Mellon Trust Company, at 1-800-387-0825.

Transfer Agent & Registrar:

CIBC Mellon Trust Company
320 Bay Street
P.O. Box 1
Toronto, Ontario M5H 4A6
Canada

SHARE LISTING

The shares of ZENON Environmental Inc. are listed for trading on the Toronto Stock Exchange under the symbols "ZEN" and "ZEN.A".

ZEN.A shares (non-voting Class A shares) are identical to ZEN common shares except with respect to voting and rights of conversion. On June 10, 2008, ZEN.A shares will automatically convert into ZEN shares on a share-for-share basis.

A copy of the Company's Annual Report may be obtained, without charge, upon request directed to ZENON's Corporate Headquarters, to the attention of the Investor Relations department.

You may also visit us on the web at **www.zenon.com**

CORPORATE HEADQUARTERS

ZENON Environmental Inc.
Investor Relations
3239 Dundas Street West
Oakville, ON L6M 4B2
Canada

NOTICE OF ANNUAL AND SPECIAL MEETING

Shareholders are invited to attend ZENON's Annual and Special Meeting to be held on Tuesday, May 13, 2003 at 4:30 p.m. at our Corporate Headquarters, 3239 Dundas Street West, Oakville, Ontario.

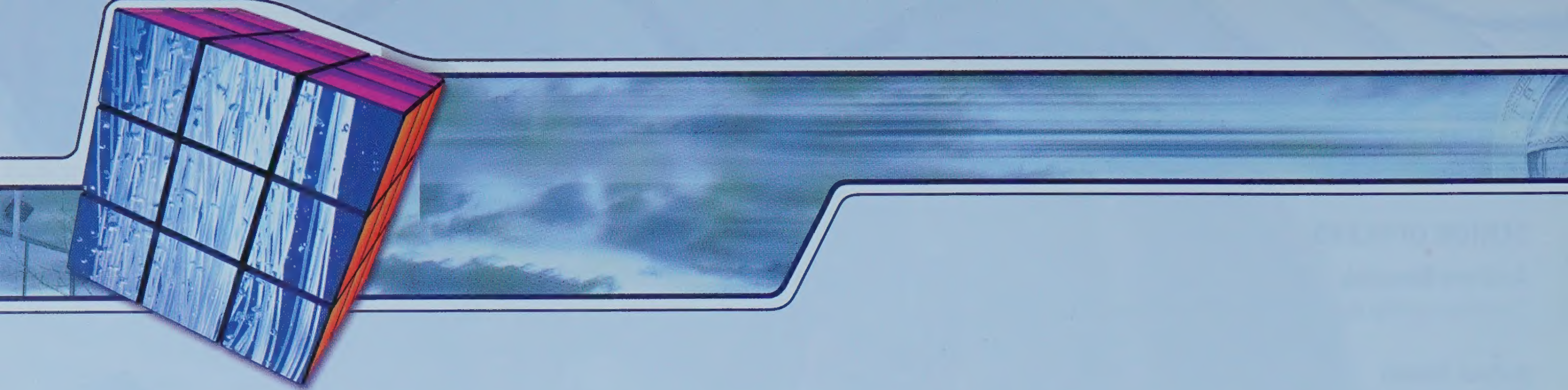
AUDITORS

Ernst & Young
Toronto, Ontario

PRINCIPAL BANKERS

CIBC
Hamilton, Ontario

Scotiabank
Toronto, Ontario



PRINCIPAL BUSINESS OFFICES

Canada
Corporate Headquarters
3239 Dundas Street West
Oakville, Ontario L6M 4B2
Canada
Tel: 905-465-3030
Fax: 905-465-3050

ZENON Environmental Inc.
9408 – 39th Avenue
Edmonton, Alberta T6E 5T3
Canada
Tel: 780-465-5451
Fax: 780-465-9929

United States
ZENON Environmental Corporation
5051 Commercial Circle, Suite B
Concord, California 94250
U.S.A.
Tel: 925-246-8190
Fax: 925-246-8199

ZENON Environmental Corporation
5130 La Jolla Blvd.
Unit #2C
San Diego, California 92109
U.S.A.
Tel: 858-488-7987
Fax: 858-488-7986

Europe
ZENON GmbH
Nikolaus-Otto-Str. 4
D-40721 Hilden
Germany
Tel: 011-49-2103-57- 03-0
Fax: 011-49-2103-98-98-50

ZENON Systems Kft.
2800 Tatabánya
Vigadó u.
P.O. Box 353
Hungary
Tel: 011-36-34-51-25-20
Fax: 011-36-34-51-25-25

ZENON Environmental srl
Via Cristoforo Colombo, 8
I-20066 Melzo (Mi)
Italy
Tel: 011-39-02-95-72-24-21
Fax: 011-39-02-95-73-67-56

Europe
ZENON b.v.
Nieuwgraaf 77 F&G
6921 RK Duiven
The Netherlands
Tel: 011-31-26-31-20-52-2
Fax: 011-31-26-31-14-61-0

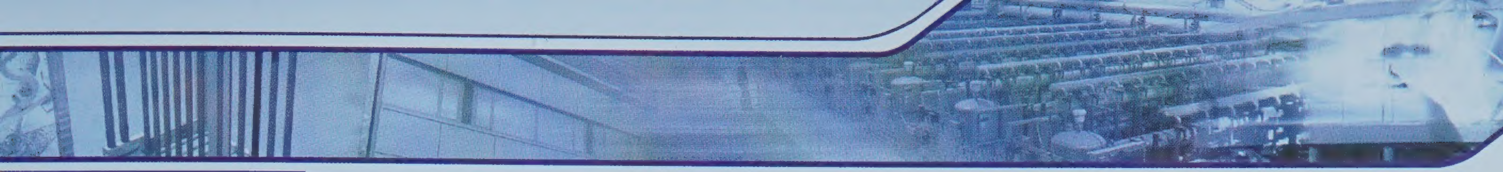
ZENON Systems Sp.zo.o.
ul. Metalowa 3
43-100 Tychy
Poland
Tel: 011-48-32-21-78-04-0
Fax: 011-48-32-21-78-04-0 Ext. 30

ZENON Environmental (UK) Ltd.
5 Stable Court
Herriard Park Estate
Herriard, Basingstoke
RG 25 2NP
United Kingdom
Tel: 011-44-125-638-1111
Fax: 011-44-125-638-1181

Latin America
ZENON Brazil
Rua Botucatu, 572 conjunto 92- Vila Mariana
Sao Paulo 04023-061
Brazil
Tel: 011-55-11-55-39-55-62
Fax: 011-55-11-55-71-01-45

Middle East
ZENON Environmental Middle East Limited
SAIF Zone
Executive Suite Z-54
P.O. Box 8733
Sharjah
United Arab Emirates
Tel: 011-971-6-557-2240
Fax: 011-971-6-557-2241

Asia-Pacific
ZENON Environmental (Asia) Pte. Ltd.
51 Newton Road
Goldhill Plaza, Unit #07-01
Singapore 308900
Tel: 011-65-63-58-06-60
Fax: 011-65-63-58-03-30



CORPORATE PROFILE

ZENON is in the business of purifying water to higher standards of quality and has been successfully doing this over the last 23 years. We have developed a water treatment technology based on membranes that filters water more efficiently and more economically than most conventional water treatment systems.

At the heart of ZENON's very focused strategy, is our patented ZeeWeed® membrane, which can be used in virtually any water source to produce safe, clean water for drinking or treat wastewater more efficiently for discharge into any environmentally sensitive area. Also, in a time of growing water shortages worldwide, ZeeWeed® is an ideal method of treating wastewater for recycling or reuse in irrigation or other non-potable purposes.

ZENON's customers are global and include municipalities, industries, government agencies, land developers and ship owners. We have 17 offices in 11 countries, including North America, Europe, Asia, Latin America and the Middle East.

We continue to add value through innovation, developing products that extend the applications of our technology over a wider range of market sectors and project sizes.

Our goal of setting higher standards of water quality, while dramatically reducing energy and chemical requirements, reinforces our commitment to solving critical water and wastewater problems around the world.

ZeeWeed! Everywhere!

ZENON Environmental Inc.
3239 Dundas Street West
Oakville, Ontario L6M 4B2 Canada
905-465-3030

www.zenon.com

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Water for the World